

FOREIGN COMPETITION AND EFFICIENCIES IN A RECENT STEEL MERGER

In deciding not to oppose Armco's acquisition of Cyclops Industries, the Department of Justice apparently recognized an important link between the efficiency analysis and the likelihood that the transaction would reduce competition. The parties had long made it clear that efficiencies, which would reduce the cost and improve the quality of finished automotive exhaust stainless steel, were the driving force behind the transaction. The Department evidently determined that the efficiencies were substantial, could not be achieved by other means (e.g., long-term contract or internal investment), and would be passed on to consumers by competition in the post-merger world. Traditional antitrust analysis weighs the potential gains from efficiencies against potential losses from anticompetitive effects. In this instance, however, the existence of efficiencies implied that anticompetitive effects would be less likely to occur at all.

With regard to foreign producers, imports clearly can be important in maintaining competition in domestic markets. Nonetheless, measuring the effectiveness of foreign competition remains a controversial issue. Armco and Cyclops were two of a small number of U.S. producers of automotive exhaust stainless steel. While the United States imported this product for many years, imports were never large, due in part to Voluntary Restraint Agreements (VRAs), which, after more than eight years, recently expired. Furthermore, the Department has long held the view that foreign firms operating under a binding VRA cannot respond to increases in domestic prices and hence should be excluded from relevant antitrust markets.

The parties argued the merger had to be analyzed in the context of an unconcentrated world market. They demonstrated that, although imports' share of domestic consumption was limited historically, foreign producers had well-established supply relationships with domestic purchasers. Moreover, foreign

producers had sufficient excess capacity to supply substantial imports without diverting shipments from other areas.

The critical link between efficiency and imports was that the efficiencies would increase the price-cost margin on each unit of sales, thereby increasing the disciplining effect of the potential loss of sales to imports. For example, if Armco were to raise the price of automotive exhaust stainless steel above pre-merger levels, sales lost to foreign competitors would represent a larger absolute amount of profit than before because, by lowering production costs, the merger would increase the profitability of all sales. As a result, the efficiency gains from the merger would reduce the number of tons Armco could lose in response to the hypothesized five percent price increase before the price increase would become unprofitable. The parties estimated that the expansion of imports that would be necessary to prevent domestic producers from profitably raising prices after the acquisition was plausible given the available excess capacity and the existing supply relationships.

The Armco-Cyclops decision is important to the steel industry because it suggests that the Department may include foreign capacity when measuring concentration in relevant steel markets in the post-VRA world. More generally, the Armco-Cyclops decision

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signals a willingness by the Department to accept efficiency claims and, by extension, to consider such claims in determining the relevant market. In the past, possible efficiency gains were considered a counterweight to the possible anticompetitive effects of a merger. Now the presence of efficiency gains may reduce the probability that anticompetitive effects will occur at all.

El Principal Joseph W. McAnney and Senior Economist Henry B. McFarland, both previously with the Department of Justice, have extensive experience in antitrust analysis. They served as economic consultants to counsel for Armco and Cyclops during the antitrust review of the companies' proposed merger. A more detailed treatment of this topic will appear in a forthcoming issue of International Merger Law.

THE CANADIAN MERGER ENFORCEMENT GUIDELINES: LESSONS FROM RECENT LITIGATION

Recently, the Canadian Competition Tribunal ruled on the first contested merger case to be litigated in Canada since the merger provisions of the 1986 Competition Act took effect. In this case, *The Director of Investigation and Research v. Hillsdown Holdings (Canada) Limited et al.*, which involved the rendering of animal by-products, the Tribunal decided not to require Hillsdown to divest Orenco, a competitor Hillsdown acquired in 1990. This decision was the first judicial test of the new Merger Enforcement Guidelines (MEGs), issued on April 17, 1991 by the Canadian antitrust authority (The Director of Investigation and Research, Bureau of Competition Policy, Consumer and Corporate Affairs). In some important respects, such as market definition, the Tribunal's decision is consistent with the MEGs. In two areas, however, concerning the issue of interdependent market power and the tradeoff between efficiencies and anticompetitive effects, the Tribunal's decision differs from the MEGs paradigm.

The MEGs specifically consider the possibility of mergers creating either interdependent market power or unilateral market power. The Tribunal's decision implies, however, that it was focusing only on the latter. Indeed, the Tribunal explicitly rejected concerns about collusion or "tacit price following" because of what it considered "the non-homogeneous nature of renderable *materials* (including differences in quality, quantity and distance from the rendering plant)." (See *Tribunal Reasons and Order*, p. 73, emphasis added.)

The Tribunal did not discuss the homogeneity of the rendering *services*, which it had identified as the product market. It also made no reference to the possibility of collusion taking the form of a market

allocation conspiracy. This decision leaves open the possibility that in the future the Tribunal will consider the question of mergers promoting interdependent pricing. Nonetheless, the decision suggests that the Tribunal will find no anticompetitive effect unless the product is homogeneous, and that the Tribunal's definition of homogeneity will be quite narrow.

The MEGs require that likely efficiencies from a merger be balanced against the merger's likely anticompetitive effects. The MEGs further explain that the anticompetitive effects considered in the tradeoff analysis are from deadweight losses, not the neutral redistribution effects of wealth transfers. In the present case, the Tribunal rejected the tradeoff analysis in the MEGs. Because of the specific wording of Section 96 of the Competition Act, the Tribunal concluded that Parliament intended to consider wealth transfers as well as deadweight losses in the tradeoff analysis.

Since enactment of the merger provisions of the Competition Act in 1986, Canadian merger enforcement policy has developed quickly. The MEGs, which are based on economic analysis, are an important step in this process. In some important respects, the MEGs have withstood their first judicial test. However, as the Tribunal revealed in this case, Canadian antitrust enforcement policy is still evolving.

Senior Economist David D. Smith has testified in a number of U.S. civil and criminal antitrust matters. Most recently, he was an expert witness for the Canadian government in the Hillsdown case. A more detailed treatment of this subject, co-authored with Randal T. Hughes, will appear in International Merger Law, June 1992.

CLEAN AIR FUTURES

On April 21, 1992 the Commodity Futures Trading Commission unanimously voted to designate the Chicago Board of Trade as a contract market in "clean air futures." This permits the CBT to trade futures contracts in the sulfur dioxide (SO₂) emission allowances that will be generated under the acid rain provisions of the Clean Air Act Amendments of 1990. Electric utilities and other participants in the SO₂ allowance market should find clean air futures to be a valuable tool for strategic planning and risk management.

Under Title IV of the Clean Air Act Amendments, EPA will implement mandated SO₂ reductions in two phases by allocating a limited number of "allowances" to plants that currently emit SO₂. Each allowance permits an electric utility to emit a total of one ton of SO₂. EPA will allocate allowances each year to achieve by the year 2010 approximately a 50 percent reduction in emissions from 1980 levels. The allowed level of emissions will be easier for some utilities to achieve than for others, so the amendments permit allowances to be bought and sold. Most utilities will find that a least-cost strategy involves some combination of (a) using the allowances initially allocated by EPA (i.e., emitting an equivalent number of tons of SO₂), (b) buying additional allowances from other sources, (c) selling excess allowances, or (d) "banking" them for use in future years. There are no restrictions on who can buy or hold allowances, so brokers, environmental groups, or even private citizens may enter the market.

While a market in emission allowances improves economic efficiency and increases utilities' flexibility in complying with standards, it does not eliminate risk and uncertainty for the utilities. That is where futures markets can be useful. A futures contract commits two parties to exchange the underlying commodity (in this case, SO₂ allowances) at a given price on a specified future date. Because all commitments are guaranteed by the futures exchange, the credit risk or even the identity of the counterparty to any trade is irrelevant to market participants. Unlike individually brokered

commitments between two parties, one can easily get out of a futures commitment in liquid markets by simply executing an offsetting transaction. In fact, the underlying commodity in a futures transaction is rarely delivered. Instead, market participants "unwind" their positions as expiration day approaches.

These characteristics are likely to make clean air futures a low-cost way to hedge against inevitable uncertainty in supply and demand forecasts. For example, best estimates of future supply and demand conditions may indicate that a utility's least-cost compliance strategy is to reduce output and sell excess allowances. However, a cold winter could increase demand enough to force the utility to purchase extra allowances in order to cover the increase in emissions. Since the increased demand would put available allow-

ances at a premium, the utility would have to purchase them at a high price. To hedge against this possibility, a utility could buy futures at a price determined today, making it feasible to plan operations and output prices with more certainty.

Utilities will not be the only beneficiaries of futures markets. Brokers and other participants in the allowance-trading market will find fu-

tures markets valuable not only for hedging, but for taking unhedged positions, if they believe prices do not properly reflect underlying supply and demand. Moreover, research has indicated that futures markets tend to make the underlying market more efficient and less volatile.

A variety of regulatory and business risks complicate compliance decisions under the acid rain regulations. Understanding how the futures market can reduce such uncertainty need not be another complication and is likely to be very helpful for utilities, brokers, and other market participants.

Senior Economist Susan Dudley specializes in environmental matters. She recently served as economic advisor to Commissioner William P. Albrecht at the Commodity Futures Trading Commission.

CLUSTER MARKETS IN ANTITRUST

The concept of antitrust "cluster markets" has recently gained attention and, under some circumstances, is likely to be accepted by the antitrust authorities. Markets are usually defined, as suggested in the government's new Merger Guidelines, by the extent to which consumers can substitute consumption among products or suppliers can switch production among products. Cluster markets, however, are based on the notion of products being consumed or produced together as complements. They have been used to define markets for general acute care hospital services that group together several individual hospital services, and to define commercial banking services markets that group together a number of banking services.

The antitrust agencies are most likely to define cluster markets containing complementary products or services in the case of transactional complements. (See Ian Ayres, "Note: Rationalizing Antitrust Cluster Markets," *Yale Law Journal* 109 (1985).) Transactional complements are goods that many buyers prefer to purchase from one firm, because of transactional cost savings, even if these buyers do not consume these products together. Examples might be various forms of interrelated hospital services or the goods sold in different departments of a supermarket. Accordingly, if transactional complementarity were strong enough for a subset of buyers, a hypothetical monopolist of interrelated products that were not demand- or supply-side substitutes may be able to raise the price of the cluster without consumers switching their purchases to firms that supply individual items in the cluster. Thus, using the Merger Guidelines approach to market definition, one might justify defining the market in such instances to include only firms supplying all elements of the cluster.

The case for defining a cluster market on the basis of transactional complementarity is likely to be bolstered by evidence that (a) consumers compare prices of the entire cluster instead of individual goods; (b) manufacturers promote their goods on the basis of joint price indices; or (c) dealers or distributors prefer

to carry a full line of products constituting the cluster and view profitability over the entire line. Conversely, the case for a product market based on transactional complementarity weakens or disappears to the degree that (a) there are numerous firms that produce only one or a small subset of the products in a cluster but compete successfully nonetheless; (b) the cluster is not well defined in that different suppliers provide different sets of products; or (c) the individual elements of the clustered product could be easily acquired and efficiently combined by purchasers.

The antitrust authorities may view with skepticism the arguments for cluster markets presented by applicants in merger cases. Applicants have an incentive

to argue for cluster markets when market shares measured in the cluster market are substantially lower than market shares measured in individual markets for "core" products in the cluster. But the theory of cluster markets does not rule out the existence of individual markets and cluster markets at the same time. On the other

hand, the government may argue for cluster markets in cases where market shares are higher in the clustered market (which omits single-product sellers) than in individual product markets.

Transactional complementarity can play a role at other analytical stages besides market definition. For example, collusion may be more difficult in a cluster market than in a non-cluster market because a collusive agreement to raise the price of one good could be undercut by firms that lower the price of one of the good's transactional complements. Thus, a successful collusive arrangement would have to agree on (and prevent cheating on) the price of the whole set of transactional complements.

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