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The DOJ/FTC Competitor Collaboration Guidelines and the Analysis of Antitrust Issues in the Insurance Industry

Collaborative activities and joint ventures play an especially important role in insurance. Recent proposals would eliminate or severely restrict the antitrust exemption that the industry has for those activities. David D. Smith considers how to evaluate the competitive effects of insurers' collaborative activities in the absence of the exemption. Economic analysis of the type underlying the Competitor Collaboration Guidelines can be used to assess whether a joint activity in the insurance business would be procompetitive.

The Danger of Misusing Effects-Based Antitrust Analysis

The FTC has increasingly relied upon an effects-based approach to antitrust analysis. Robert A. Kneuper describes this approach, which stresses a showing of actual or potential anticompetitive effects and deemphasizes other economic issues, such as market definition. An effects-based analysis has a great advantage in that it focuses on the bottom-line issue of antitrust. Even so, a number of dangers are associated with this trend, including a failure to develop a coherent theory to explain the anticompetitive effects as well as a failure to take into consideration procompetitive effects.

Antitrust Review in China's New Merger Regulation

Su Sun reviews the antitrust component of China's newly issued regulation on foreign acquisition of domestic companies. He discusses merger notification and antitrust analysis in the context of China's draft Antimonopoly Law. He argues that the merger review efforts are likely to increase in the future as China institutes its Antimonopoly Law.

The DOJ/FTC Competitor Collaboration Guidelines and the Analysis of Antitrust Issues in the Insurance Industry

By David D. Smith

Insurance has had special treatment under the federal antitrust laws since the McCarran-Ferguson Act was passed in 1945. In particular, insurers now have an antitrust exemption for collaborative activity that constitutes the business of insurance and is subject to state regulation. There have been occasional efforts to repeal this exemption, and the exemption has been the subject of a recent Senate hearing and a proposed bill that Congress will probably consider in early 2007. The McCarran-Ferguson Act may be repealed or, as advocated by the American Bar Association ("ABA"), replaced with language providing only certain limited "safe harbor" protections.

If the antitrust exemption is eliminated or severely restricted, collaborative behavior among insurers will face increased scrutiny. In particular, if the ABA's language is adopted, disputes will likely focus on balancing efficiencies with potential anticompetitive effects to determine whether certain collaborative behavior would "unreasonably restrain competition" or "interfere with competitive pricing." A useful framework for addressing such disputes is in the DOJ/FTC's April 2000 Antitrust Guidelines for Collaborations Among Competitors ("Competitor Collaboration Guidelines"). Economic analysis of the type underlying the Competitor Collaboration Guidelines can be used to assess whether any particular joint activity in the insurance business would be procompetitive.

Explain the business justification for the activity. The reasons given for the collaborative activity provide a good starting point for analyzing its competitive effects. Many of the reasons for collaborative activities in the insurance business are well known. For example, the pooling of loss data can help reduce insurance company risks and result in lower insurance prices. Because of the law of large numbers, insurance companies get better information with larger amounts of loss data. Pooling loss data helps all insurance companies to understand risks better and to price more efficiently.

Correctly define the product and geographic markets to be analyzed. Market definition is an important step in any economic analysis of competition. The basic principles of the Merger Guidelines help define insurance markets. Indeed, the market definition section of the Competitor Collaboration Guidelines (§3.32) is based on the Merger Guidelines. Markets are defined by analyzing substitutability from the perspective of insurance consumers. Next, competitors in the market are identified by considering substitutability on the supply side. In the insurance business, relevant markets are often defined as specific lines of insurance in individual states because of consumer preferences and regulations limiting demand side substitutability. (For example, to insure a car in Virginia, the owner needs auto insurance, not medical malpractice insurance, and must purchase the insurance from a company licensed to sell in Virginia.)

Calculate market shares and concentration in the market. The Competitor Collaboration Guidelines establish a safe harbor where the Agencies will "not challenge a competitor col-

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The Danger of Misusing Effects-Based Antitrust Analysis

By Robert A. Kneuper

In recent years, the FTC has increasingly relied upon an effects-based approach to antitrust analysis. Under this approach, a showing of actual or potential anticompetitive effects forms the starting point of the antitrust analysis while other economic issues, such as market definition, concentration and entry barriers, take a back seat. In some cases, such as consummated mergers, the alleged anticompetitive effects have already occurred. In other cases, the alleged anticompetitive effects are predicted from merger documents and associated data. Regardless of the approach, it is imperative, although sometimes ignored, that a consistent theoretical rationale for any alleged competitive harm be developed. Moreover, pro-competitive effects and alternative explanations for price increases must be considered.

Perhaps the most notable example of a case based on predicted anticompetitive effects was the FTC's case against the merger of Staples and Office Depot, two of the three existing office supply superstores. That case focused primarily on documents and data allegedly showing that office supply prices would increase as a result of the merger. This evidence formed the centerpiece of the FTC's case, and the other elements of the case were developed consistent with that focus. For example, the FTC's market definition in this case, office consumables sold by office superstores, was a logical derivation of the alleged price increases.

Other more recent cases have used a similar effects-based analysis. In Schering, the FTC's market power analysis was largely based on studies and documents showing that entry of a generic version of K-Dur 20, a branded prescription potassium chloride supplement, would lower prices. Thus, an agreement delaying such entry was viewed as anticompetitive. The corresponding market definition consisted of K-Dur 20 and its generic counterpart. A number of other potassium chloride supplements were being sold, but they were left out of the FTC's defined market because K-Dur 20 was the only 20 milliequivalent (MEQ) sized supplement and because the generic pricing effect was confined to the 20 MEQ category.

From an economic perspective, this trend towards focusing on actual or likely anticompetitive effects has significant advantages. The main advantage of a direct-effects analysis is the focus on the bottom line of antitrust analysis - anticompetitive effects. Nonetheless, the FTC's experience points to a number of dangers associated with the potential misuse of an effects-based antitrust analysis. These dangers come from a potential overemphasis on effects at the expense of other elements of an antitrust case. For example, effects-based antitrust analysis will go astray if its practitioners ignore the need to rely on a coherent anticompetitive theory. Antitrust enforcers might focus so heavily on showing actual or likely anticompetitive effects that they fail to provide a theory that links these effects to anticompetitive behavior. Likewise, other important elements of the case, such as the merger's pro-competitive benefits, should be taken into account. In addition, it is critical in an effects-based analysis to consider other potential causes for a price increase.

In the Evanston Northwestern Healthcare merger retrospective investigation, the FTC focused primarily on anticompetitive effects. In this case, the merger had already been consummated, and the FTC focused on evidence of post-merger price increases to managed care plans. The FTC's Chief Administrative Law Judge (ALJ) supported the FTC's case and put forth a market consisting of "general acute inpatient services sold to managed care plans" in a seven-hospital geographic area. Some critics argue that the FTC focused so much on price increases after the merger that it failed to develop a coherent story as to why the merger might have caused those price increases. These commentators point to the ALJ's reliance on a unilateral antitrust theory while also finding that several other hospitals were more closely competitive with the merging hospitals than the merging hospitals were with one another.

Another danger associated with effects-based antitrust analysis is that it can fail to consider the full range of effects, including procompetitive effects. This criticism was put forth by some in the Schering case. In that case, critics claim that the FTC focused solely on the generic entrant's effect on price and failed to consider the economic effects associated with a loss of promotional activity after generic entry. A delay in generic entry may delay a decline in drug prices but may also delay the end of beneficial promotional activities. A complete analysis should consider both of these effects.

In addition, effects-based antitrust analysis also may fail to distinguish effects resulting from the creation or enhancement of market power from effects that are explained by other reasons. An acquiring firm may plan to raise prices for reasons other than the creation or enhancement of market power. For example, a merger may be followed by higher prices simply because the acquiring company provides better quality or service. A narrowly focused effects-based analysis may inappropriately conclude that such a merger is anticompetitive because prices are likely to increase, even though quality-adjusted prices are not likely to increase.

In sum, the FTC's shift towards effects-based antitrust analysis has significant advantages particularly since it focuses the analysis on the bottom-line issue of antitrust analysis. Even so, a number of dangers are associated with this trend, including the failure to develop a coherent theory to explain the anticompetitive effect as well as a failure to take into consideration both anti- and pro-competitive effects. The increasing emphasis on anticompetitive effects should not come at the expense of developing sound economic theories of competitive harm.

Robert A. Kneuper joined EI after analyzing antitrust matters for over 10 years at the FTC. While at the FTC, he worked on numerous mergers and played a major role in developing the policy for cases involving patent settlements.

Antitrust Review in China's New Merger Regulation

By Su Sun

China's "Rules on Acquisition of Domestic Enterprises by Foreign Investors" (the Rules) took effect on September 8, 2006. The rules were jointly issued by six government agencies. Chapter Five of the Rules outlines the merger notification thresholds and the antitrust review process. These provisions first appeared in the Provisional Rules that were issued in 2003. According to Chinese officials, so far no foreign acquisition of a domestic company has been blocked because of antitrust concerns. Nonetheless, the antitrust review of foreign acquisitions will likely become a more contentious issue for two reasons. First, as foreign acquisitions have become more prevalent in China, some Chinese government agencies and industry groups have expressed more concerns about the potential anticompetitive effects of such acquisitions. Second, since 2003 China has made significant progress in the drafting of an Antimonopoly Law. In this process, Chinese officials have learned from countries with established antitrust policies and have become more confident in their ability to enforce such a law. Thus, a careful analysis of the antitrust review in the Rules is important for multinational companies interested in making either acquisitions in China or acquisitions outside China that affect commerce in China.

> "...as foreign acquisitions have become more prevalent in China, some Chinese government agencies and industry groups have expressed more concerns about the potential anticompetitive effects of such acquisitions."

Merger notification requirements in the rules are generally helpful for safeguarding competition but can be improved. Most notably, Article 51 provides that if any one of the following conditions is met, parties need to report the acquisition to the Ministry of Commerce (MOFCOM) and State Administration of Industry and Commerce (SAIC): (1) One party to the acquisition had an annual turnover in the Chinese market during the current year exceeding RMB1.5 billion ($192 million at current exchange rates), (2) The foreign investor acquired more than ten enterprises in related industries in China within one year, (3) One party to the acquisition already has more than a 20% market share in China, (4) The acquisition will result in the acquiring firm's market share in China exceeding 25%. Article 53 provides similar notification thresholds for mergers outside China that may pose an anticompetitive threat to the Chinese market.

The use of the number of acquired enterprises "in related industries" and "market shares" as notification thresholds is generally considered inappropriate because both the classification of industries as related and the market definition, which determines market shares, are oftentimes controversial. Assets or sales revenue data are objective measures according to the International Competition Network's recommended practices regarding merger notification thresholds and review procedures. Indeed, only the previous year's sales level is used as a threshold in China's current draft Antimonopoly Law. Chinese officials seem to have recognized this problem and a revision of the thresholds in the Rules is expected once the Antimonopoly Law is promulgated.

The Rules provide little guidance on how MOFCOM and SAIC will analyze the competitive effects of foreign acquisitions in the Chinese market. The Rules say only that if the agencies think that the acquisitions may result in over-concentration that restricts competition and harms consumer interests, they may conduct hearings within 90 days of receiving the notification. However, because both MOFCOM and SAIC have been the main participants in drafting the Antimonopoly Law, the relevant provisions of that law may indicate how foreign acquisitions will be analyzed in the enforcement of the Rules. The current draft Antimonopoly Law devotes a chapter to merger review and provides several factors to consider: (1) Merging parties' market shares in the relevant market

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EI News and Notes

FERC Grants Market-Based Rates for Tampa Electric

John Morris submitted a delivered price test (DPT) in support of Tampa Electric Company's request to sell electric power to Reedy Creek at market-based rates. In December 2006 the Federal Energy Regulatory Commission accepted this analysis and concluded that "based on Tampa Electric's DPT analysis of the Reedy Creek control area, Tampa Electric has rebutted the presumption of generation market power and satisfies the Commission's generation market power standard for the grant of market-based rate authority.

The Cost of Piracy to the Motion Picture Industry

The True Cost of Motion Picture Piracy to the U.S. Economy, a study by Stephen E. Siwek, was recently released by the Institute for Policy Innovation. Because motion pictures are expensive to produce but cost little to reproduce, they are a frequent target of pirates. The study found that the cost of motion picture piracy extends beyond the movie producers themselves to suppliers and media outlets. The total cost to the U.S. economy is over $20 billion annually, including 141,000 jobs, $5.4 billion in lost employee earnings, and $837 million in lost tax revenue.

FTC Post-merger Investigation of Physician Group

The FTC recently terminated a lengthy post-merger investigation of Pediatrix Medical Group, a national neonatology physician group. David A. Argue and Barry C. Harris worked with Sidley & Austin, Hogan & Hartson and Kaye Scholer to analyze several aspects of competition by these hospital-based physicians, including market definition and structure, competitive dynamics, post-merger price changes and potential remedies. They argued for a national market with competitive discipline provided by hospitals and managed care plans. Their econometric analysis showed that post-merger prices rose in line with competitive benchmarks.

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laboration when the market shares of the collaboration and its participants collectively account for no more than twenty percent of each relevant market in which competition may be affected." (§4.2) In the insurance industry, where collaborations, such as sharing loss data, tend to be industry-wide, many collaborations will not meet this standard. A collaboration that does not meet the safe harbor standard, however, is not necessarily anticompetitive. Market share and concentration are only a starting point for the competitive analysis and not the final word.

Analyze market entry conditions. The easier entry is into a market, all else equal, the less likely are anticompetitive effects. Attempts to raise price above the competitive level would be undermined by entrants undercutting price. The entry section of the Competitor Collaboration Guidelines (§3.35) is based on the Merger Guidelines. Using the standards of the Merger Guidelines, entry is considered relatively easy if it would take place in less than two years. If the market is the sale in a specific state of a specific type of insurance, entry could come from insurance companies in the same lines of business in other states, or insurance companies in different lines of business in the same state.

Determine the significance of the efficiencies and whether the activity is "reasonably necessary" to produce them. Efficiencies are difficult to verify and measure, especially when they are prospective. Both the magnitude and the likelihood of future efficiencies are needed to evaluate their expected value. It is also necessary to determine whether the efficiencies require the specific collaborative activity under consideration or can be achieved in some less anticompetitive way. The larger the expected efficiencies, and the more closely they can be linked to the joint behavior, the more weight they can be given. The competitive effects of a joint venture are analyzed by comparing the expected anticompetitive effects with the procompetitive efficiencies. The balance tips toward collaboration whenever the anticompetitive effects can be reduced relative to the efficiencies.

Although collaborative activities and joint ventures are present in many industries, they play an especially important role in insurance. Recognition of the business justifications of these collaborative activities was a key rationale for the McCarran-Ferguson Act. If McCarran-Ferguson is repealed or replaced with the ABA's proposal, economic analysis guided by the Competitor Collaboration Guidelines can determine the net competitive effect of joint activities in the insurance industry.

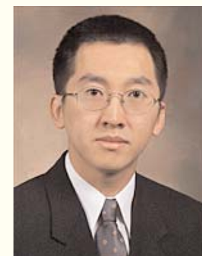
David D. Smith has extensive experience analyzing competition in the insurance industry. He has dealt with this industry both at EI and in his previous position at the Antitrust Division of the U.S. Department of Justice.

China's New Merger Regulation . . . . Continued from Page 3

and their ability to control the market; (2) Concentration in the relevant market; (3) The potential for the merger to exclude or limit competition in the relevant market; (4) The merger's effect on entry and technological progress; (5) The merger's effect on consumers and other business operators; (6) The merger's effect on national economic development and the public interest; (7) Other factors the enforcement agency deems necessary to consider.

Many of these factors are commonly considered in merger review in other jurisdictions. Their applications in China can be better understood in the context of other articles in the draft Antimonopoly Law and other laws. For example, the definition of relevant market is provided in Article 4 as products and services that compete, and it can have both a product dimension and a geographic dimension. The ability to control the market may be studied in connection to the discussion of "dominant market position" provided in Articles 13 and 14. China's concerns over the possible effect of foreign acquisitions on suppressing domestic technological progress can be seen in its recent efforts to amend the Patent Law. Some other factors are more controversial (effect on competitors) or vague (effect on national economy and public interest). Nevertheless, Chinese officials have indicated on various occasions a strong interest to enforce the Rules and a future Antimonopoly Law consistent with sound economics and best international practice.

China's regulations on foreign acquisition of domestic companies show that Chinese authorities want to study the competitive effects of foreign acquisitions that occur with increasing frequency in China today. Though still at an experimental stage, such efforts are likely to be increased as China comes closer to enacting its first Antimonopoly Law that includes a comprehensive merger review regime.



Su Sun has provided economic analysis in a number of merger cases in EI's Washington DC office. He has written in both English and Chinese on China's antitrust development.

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INCORPORATED

Suite 400	Suite 250
1200 New Hampshire Ave.	5980 Horton Street
Washington, DC 20036	Emeryville, CA 94608
Phone: (202) 223-4700	(510) 547-6910
Fax: (202) 296-7138	(510) 547-5162

Website: www.ei.com

President, Jonathan L. Walker; Editor, Henry B. McFarland
Layout, Gregory E. Wurz
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