a brief analysis of policy and litigation
spring/summer 1999

Economists Incorporated is pleased to present our redesigned *Economists Ink*. It still features the brief analyses of policy and litigation by our staff that you have been reading for the past nine years. This new format is intended to be easier to read and it includes some improved features. I hope that you continue to find *Economists Ink* useful.

Bruce M. Owen

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Joseph W. McAnneny and Michael G. Baumann discuss the court's decision in *U.S. v. Englehard Corporation* in which the government's apparently overly strict interpretation of the Merger Guidelines was balanced by the court with other evidence.

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Barry C. Harris and David A. Argue discuss the likelihood of harm to competition from "most favored nation" clauses in health insurance. They find that below-MFN discounts may be profitable more often than believed and thus help prevent harm to competition.

Reasonable Interchangeability And The 5 Percent Test

By Joseph W. McAnneny & Michael G. Baumann

In June of 1995, the Justice Department sued Engelhard Corporation and the Floridin Company to stop a proposed production joint venture. Both companies produced gellant quality attapulgite clay (gel clay). Using a strict application of the Merger Guidelines, the Department alleged that gel clay was the relevant product market, that the market was highly concentrated, and that neither the proposed competitive-rules joint venture nor the potential efficiencies stemming from the joint venture were sufficient to allow the transaction to proceed. In March 1997, the court found that the Department had not met its burden with respect to market definition and ruled for the defendants. The District Court and the Eleventh Circuit Court rejected the Department's appeals, and the Department chose not to appeal to the Supreme Court. Recently the trial court unsealed the record in the matter.

As in many antitrust cases, the key issue in deciding *U.S. v. Engelhard Corporation* was market definition. Gel clay is used as a thickener or suspension agent in a number of applications, including paints, tape joint compounds, suspension fertilizers and asphalt roof coatings. In virtually every application, however, many producers use alternative materials instead of gel clay. During the trial, the Department narrowly applied the Merger Guidelines market definition paradigm (i.e., the profitability of a small but significant price increase imposed by a hypothetical monopolist). The Department argued that alternative materials were not "drop in" substitutes for gel clay. The use of alternatives would require reformulation and reformulation costs generally exceeded the 5 percent or even 10 percent test espoused in the Merger Guidelines. Consequently, the Department concluded that alternative materials were not in the relevant market. The Department also argued that it was irrelevant that some customers had already switched from gel clay to alternative materials at current prices and that some customers said they would switch if faced with a slightly larger price increase.

The merging parties argued that because all inputs were replaceable, the relevant competition occurred when the products were formulated or reformulated. In addition, reformulation was an ongoing process, and a gel clay supplier would not raise price once it had won the formulation competition for fear of being excluded from the next round of product formulation. Finally, the merging parties countered that evidence regarding customers who had already switched to other materials was extremely important in understanding the market. While it is true that customers who have already shifted to other products cannot discipline a price increase, the behavior of those customers is informative about the likelihood of substitution by the remaining customers in response to a price increase.

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Competing With District Energy: Market Definition

By Mark W. Frankena

The U.S. Department of Justice and the Federal Trade Commission have recently indicated that the activities of electric and natural gas utilities will undergo increasing antitrust scrutiny in light of the growing reliance on competition rather than regulation in the electric power and natural gas industries. In 1998, the Department of Justice stated that its settlement in *U. S. v. Rochester Gas & Electric* "sends a clear message to electric utilities throughout the country that their conduct must conform to the antitrust laws."

The behavior of utilities toward district energy companies is one of the areas that raises risks of antitrust problems. District energy companies supply steam and chilled water to office buildings, universities, hospitals and others in the downtown areas of many cities in the United States and Canada. Proper delineation of antitrust markets in which electric and gas utilities and district energy companies compete and interact is critical to identifying potential antitrust problems. Market delineation is complicated, however, by the variety of uses of the products, the levels of trade at which the producers interact, and the producers' ability to price discriminate.

In the methodology employed by the antitrust agencies, one dimension of market definition is product markets. One set of relevant product markets in which district energy companies and utilities compete is likely to be retail energy delivered to buildings in the form of steam, chilled water, electricity and natural gas, or various subsets of these forms. Steam and chilled water compete at retail with electricity or natural gas for space heating and cooling, cooking, laundering, industrial processes and other applications.

Price discrimination among energy uses often leads to separate relevant product markets. The relevant product market for space cooling, for example, may include chilled water as well as electricity and steam used to drive on-site chillers. Utilities often price discriminate by offering incentives for installation of certain types of equipment, such as electric boilers and chillers, or for "all electric" buildings. Utilities may also use separate meters and charge lower prices for electricity and gas used for specific types of equipment for which they face the greatest competition from district energy companies.

The other dimension of antitrust market definition is geographic markets. One relevant geographic market in which a district energy company and the local electric or gas utilities are likely to compete is the area served by the district energy system's distribution pipes, or a somewhat larger area that the district energy system would be likely to serve if electricity or gas prices were to increase by a small but significant amount.

As with product markets, price discrimination adds complexity to geographic market definition for retail energy. Different geographic markets may exist because electric and gas utilities can price discriminate by discounting prices or offering other incentives for large customers in areas served by district energy companies. Electric and gas utilities and district energy companies may also be able to price discriminate among users within the areas served by the district energy companies. For example, because competitive conditions and prices may differ for existing buildings that do not have on-site boilers and chillers and for buildings that have not yet been constructed, relevant markets may be smaller than the entire area served by the district energy company.

In addition to competing with utilities in retail markets for energy delivered to downtown buildings, district energy companies may compete with electric utilities in wholesale markets for electric power. District energy companies are competitors in those markets if they operate cogeneration (combined heat and power) facilities and have not already sold their electric power outputs under long-term contracts. Separate relevant product markets for electric power generally include capacity, electric energy, and ancillary services such as voltage control.

Relevant geographic markets for wholesale electric power are sometimes difficult to delineate because they depend on specific facts regarding costs of generation and transmission and load patterns in a wide region. In other cases, however, geographic markets are easily delineated based on transmission constraints.

When geographic markets for any of these products are narrow, problems of market power and monopolization may arise because the market shares of utilities and market concentration are typically high and entry barriers are generally substantial. Even if concentration or entry barriers are not high for production of steam, chilled water, electric power or natural gas, concentration and entry barriers are likely to be high at the local distribution stage because of economies of scale and regulation.

During the past six years, district energy companies operating in three cities have sued the electric utilities in U.S. federal courts on antitrust grounds, and others have filed complaints with regulatory commissions. More such cases appear likely. Sorting through the complexities of market definition will be an important part of the analysis of these issues.

Principal Mark W. Frankena is a former deputy director for antitrust in the Bureau of Economics of the Federal Trade Commission. A more detailed treatment of these issues is in CCH Power and Telecom Law, *July/August 1999.*

Most Favored Nation Clauses In Health Insurance

By Barry C. Harris & David A. Argue

It has increasingly become common for health insurers and health care providers to enter into contracts with "most favored nation (MFN)" clauses. The courts and the antitrust agencies have reviewed several of these agreements and believe that they can be anticompetitive. The primary theory under which MFN agreements are considered to be anticompetitive is that a "dominant" health insurer can force a large number of providers to accept an MFN, thereby reducing the providers' willing-ness to discount to other plans. This theory assumes that providers are compelled to accept an MFN agreement in order to retain patient volume. As a result of the MFN, other health insurers thus become less effective competitors, entry of new plans is thwarted, and competition is harmed. A closer examination of MFN clauses indicates that the likelihood of harm to competition is more remote than the courts and the agencies appear to believe.

In an MFN, a provider and an insurer typically agree that the MFN plan will receive the same (or greater) discount from the provider as any other plan. If the provider offers another insurer a greater discount, the provider is penalized by the difference between the MFN rate and the below-MFN rate for all of the MFN plan's volume.

If without the MFN clause the provider would not charge other plans lower rates than the MFN rate, then the provider is indifferent between accepting or rejecting the MFN clause. In these circumstances the MFN clause has no effect on rates or competition. If, however, the provider wants the ability to charge competing plans lower rates than are allowed by the MFN clause, then its acceptance of the clause may disadvantage the provider in competing for the business of other plans. In deciding whether to accept an MFN clause, each provider weighs the potential loss of that plan's business against the potential loss of business from other plans if it does accept an MFN clause.

The acceptance of an MFN clause does not eliminate the provider's ability to offer other medical plans discounts greater than the MFN discount, but it becomes more expensive for the provider to do so. The incentive for the provider to discount to other plans is determined by (1) the extent to which the discount is below the level allowed by the MFN clause, (2) the profitability associated with business from plans receiving the below-MFN discount, (3) the share of the provider's business covered by the MFN clause, and (4) the share of all business in the area accounted for by the MFN plan. An MFN agreement with an insurer that accounts for a small share of a provider's revenue does not significantly reduce the provider's incentive to compete. For example, consider a hospital with a typical revenue-cost structure (i.e., a variable contribution margin of 60 percent) that receives 15 percent of its $100 million in revenue from the MFN plan. If the hospital were to offer other insurers prices 5 percent below the MFN plan's rates, the hospital would have to pay a $750,000 penalty to the MFN plan ($100 million x 15 percent x 5 percent). Offering the 5 percent below-MFN discount (and paying the penalty) would be profitable, however, if the below-MFN discount increases the provider's revenues as little as $1.25 million, or 1.5 percent of its non-MFN revenue. Even if the MFN plan accounts for 60 percent of the provider's revenue, a

> "The likelihood of harm to competition from MFNs is more remote than the courts and agencies appear to believe."

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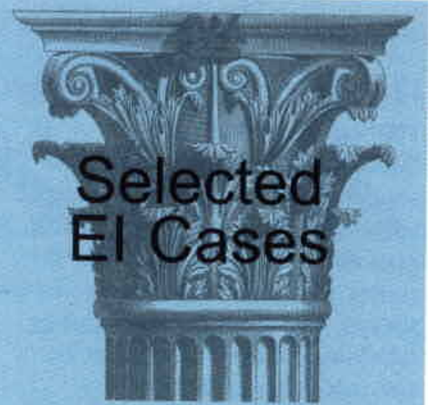

Selected EI Cases

Burlington Drug v. VHA et al.

Principal Barry C. Harris analyzed plaintiff's allegations that an exclusive contract between VHA, a hospital association with a pharmaceutical purchasing program, and Cardinal Health, a pharmaceutical distributor, foreclosed rival distributor Burlington Drug from selling pharmaceuticals in New England. Harris argued that VHA had no incentive to help Cardinal to increase its prices. Among other things, Harris showed that sales well in excess of the amount plaintiff said it needed to be viable remained available to the plaintiff. The case, which was litigated for VHA by Mayer, Brown & Platt and for Cardinal Health by Baker & Hostetler, settled before reaching trial.

Tobacco Settlement

Vice President Michael G. Baumann, Senior Economist Gale Mosteller and EI Director Robert W. Crandall have analyzed the impact of various proposed national tobacco settlements, including the 1997 proposed global tobacco settlement, congressional proposals, and the 1998 Master Settlement Agreement (MSA). Working with counsel from Kirkland & Ellis and Jones, Day, Reavis & Pogue, they developed models to assess the effect of these proposals on the price and quantity sold of cigarettes and to determine the total payments from the cigarette companies. Currently, they are participating in the arbitration proceedings to determine the fee awards to outside counsel under the terms of the MSA.

Reasonable Interchangeability . . . (Continued from Page 1)

The court determined that the Department's rigid application of the 5-10 percent test did not provide an accurate picture of the relevant product market. In particular, the court noted that the two parties' gel clay products are not identical, and one producer's gel clay cannot be substituted for another's without the customer incurring the cost of reformulation. Thus, changing gel clay suppliers would require product testing and potential reformulation. Under the Department's approach, the court reasoned, these two suppliers of gel clay would not be in the same market.

The use of gel clay and other thickeners in paints provides an example of why the court rejected the Department's argument that alternative materials for gel clay were not in the same market. The Department contended that while many thickeners exist, they could not and do not compete with gel clay in those applications that use gel clay. The premise of the Department's argument was that specific applications required specific results and hence small variations in end-use requirements could be enough to preclude head-to-head competition. For example, the Department argued that gel clay was used in certain kinds of paint. As the court observed, however, the government's witnesses testified that some companies made all of their oil-based paint without gel clay while others used only gel clay in such formulations. Moreover, some companies made all of their water-based paints without gel clay while others used only gel clay in such formulations. The court concluded that the same type of paint could be manufactured at competitive prices with or without gel clay. Hence, the reluctance to change formulas was not based on a lack of competitive alternatives within the relevant market, but on the competitive cost of gel clay in the paint formulation.

Finally, the court also may have been influenced by the parties' argument that the Merger Guidelines are just that—a set of guidelines—and they are not binding on the court. The Guidelines are useful as a screening mechanism to assist the Department in reviewing the large number of transaction it faces in the normal course of business. At times, however, one must go further to define relevant markets during litigation. The court apparently found that the Department's strict application of the 5-10 percent test was masking evidence of reasonable interchangeability, the standard proposed by the parties.

The use of the Merger Guidelines market definition paradigm may be a two-edged sword. On the one hand, the paradigm provides a powerful insight for merger analysis by focusing on the dynamic consequences of a merger. On the other hand, a strict application of the paradigm may obscure useful evidence in the evaluation of a merger. The court appears to have recognized the importance of striking an appropriate balance.

Principal Joseph W. McAnneny and Vice President Michael G. Baumann provided expert economic testimony on behalf of the merging parties in U.S. v. Englehard Corporation.

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5 percent below-MFN discount is profitable if it generates as little as $5 million, or 12.5 percent of its non-MFN revenue.

The likelihood of a provider receiving enough incremental revenue for a below-MFN discount to be profitable depends in part on the share of overall business in the area by non-MFN plans. If the MFN plan has a small share of all patients in the area, the necessary incremental revenue may be easily obtained by the provider, even if the MFN accounts for a large share of the provider's revenue. If, however, the MFN plan accounts for a large share of all patients in the area, it may be difficult for other plans to shift enough additional volume to the provider to make a below-MFN discount profitable.

It is apparent that under a range of scenarios, an MFN clause is not likely to harm competition. Even after entering into an MFN agreement, a provider continues to choose a discount that maximizes profits. That discount may coincide with the MFN discount or it may be below the MFN discount. The question of anticompetitive consequences of an MFN agreement must be analyzed in the context of the amount of incremental revenue necessary to make a below-MFN discount profitable and the likelihood of receiving that incremental revenue.

Principal Barry C. Harris and Senior Economist David A. Argue have worked extensively in antitrust analysis of health care issues including those involving health insurance products.

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