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A BRIEF ANALYSIS OF POLICY AND LITIGATION
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MasterCard and Visa Antitrust Settlement

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The Department of Justice (DOJ) and seven states recently filed a civil antitrust lawsuit against MasterCard, Visa and American Express to challenge restraints on merchants' ability to offer consumers discounts, rewards or cost information to promote the use of competing cards. DOJ argued that the restraints reduced competition among the card issuers and raised costs to merchants and consumers. DOJ announced a proposed settlement with MasterCard and Visa, while litigation against American Express continues.

Visa, MasterCard and American Express provide network services for authorizing, settling and clearing payments. The market for these services is a classic example of a two-sided market. Each network connects two groups of customers: cardholders and merchants. Network externalities arise because cardholders value a brand of card more if more merchants accept it and merchants value a brand more if more cardholders carry it. Also, usage externalities arise because cardholders consider only their own costs and benefits, not those of merchants, when choosing which card to use.

In two-sided markets, suppliers structure their pricing to attract an appropriate balance of both types of customers. In this case, merchants must pay a "swipe fee" every time a consumer uses a brand's card. The swipe fee is generally lower for debit cards than for credit cards and higher for credit cards with richer rewards programs. Merchants pay approximately $35 billion in swipe fees each year. Cardholders face relatively low prices for services and may even be rewarded for participating. However, consumers may be hurt by higher swipe fees if these are passed through in the form of higher retail prices.

The DOJ suit directly targets only the merchants' side of the market. Each network required member merchants to abide by rules that restricted their ability to steer consumers towards lower-cost payment methods. Such rules prohibited offering discounts or other incentives for using a lower-cost card, promoting a competitor's card, and sharing information about the relative costs of different cards. DOJ contends that these rules reduce interbrand competition and help to maintain high swipe fees. The proposed settlement with Visa and MasterCard weakens or eliminates these rules. For example, Visa and MasterCard now must allow merchants to offer discounts or otherwise promote the use of debit cards or even credit cards from specific issuing banks. DOJ hopes that merchants will use these measures to promote the use of lower-cost cards, thus reducing their costs and encouraging more efficient card use by consumers.

Dodd-Frank Financial Reform: Non-Market Risks and Strategies

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The *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010* promises to strengthen financial market performance by, among other things, "improving accountability and transparency." The Dodd-Frank Act, however, appears to create risks for economic performance through at least two channels. Its reforms to board governance both in the Federal Reserve System (the Fed) and in public corporations may increase "accountability and transparency," but may also risk institutionalizing more inflationary monetary policy and less productive business associations.

While Dodd-Frank's changes in corporate governance reforms have received more attention, its changes to how the Fed is governed may be just as or even more important. Lawmakers have long criticized presidents of the Fed's District Banks for lacking accountability to the public. An important part of this problem, it is argued, is the conflict of interest that comes from allowing private-sector directors (who work for banks) to vote for District presidents (who regulate banks). Dodd-Frank attempts to remove this conflict by taking away the ability of Class A directors (who are nominated by and represent member banks) to vote for District presidents.

But increasing accountability in this manner may also compromise an important firewall against political pressures for inflation. Commercial bankers have a financial stake in low inflation; their assets are loans, the value of which decreases with the prospect of being paid back with a weaker currency. Moreover, other members of the Fed's monetary policy committee (i.e., Federal Reserve Board Governors) are already more accountable to the public and, according to academic studies, have long favored looser monetary policy than do District presidents. The Act's weakening of commercial bankers' role in the monetary policy process may thus institutionalize a more accommodative stance on inflation.

Dodd-Frank's attempt to increase corporate management's accountability to shareholders also appears to create new risks. Under the Act, the Securities and Exchange Commission (SEC) has stronger authority to (a) ease shareholder access to corporate proxies and (b) require corporations to give shareholders a non-binding "Say on Pay." These provisions aim to strengthen the ability of shareholders to monitor and control their managerial agents, but may also make incorporation a less productive form of business association.

Rather than improve corporate governance, the Act's strengthening of shareholder power may threaten the interests of other corporate stakeholders. Indeed, research highlights how these stakeholders may respond in ways that protect themselves but weaken business performance. Bond market participants, for example, may demand higher interest rates to compensate for the prospect of boards' overly favoring shareholders' preferences for relatively risky projects. And suppliers of human capital, such as individuals offering managerial talent, may demand insurance-like measures to offset an increased risk of having their firm-specific investments expropriated. Finally, anti-takeover provisions may increasingly become a part of initial public offerings (IPOs) if, in this new institutional setting, non-owner stakeholders face greater risks from opportunistic changes in control upon going public.

Understanding how boards become exposed to new risks when various groups strategically anticipate and react to institutional changes is important for developing legal, operational and transactional strategies that consistently succeed in a rapidly evolving regulatory environment. Organizational planners, for example, can benefit from measuring the increased risks of going public under a corporate law that now gives shareholders a stronger voice in both governance and business judgments. Those planners also should consider how charters and bylaws might mitigate the potential for and consequences of those increased risks.

Risk managers in legal, operational and transactional roles can also benefit from a deeper understanding of Dodd-Franks' reforms to board governance of both

continued on page 4

New Concern with Buyer Market Power: The *Adobe* Case and the New Guidelines

Gloria J. Hurdle

Gloria J. Hurdle has submitted testimony and testified at deposition on economic damages in a number of employment matters, including discrimination, wrongful termination, and accidental injury. She also has testified on antitrust issues related to airline and other transportation matters.

The Department of Justice Antitrust Division (DOJ) has shown increased interest in buyer market power both in a recent case and in the new *Horizontal Merger Guidelines*. DOJ recently filed a complaint against several high tech firms that had agreed not to "cold call" each others' employees. The complaint in this case, *U.S. v. Adobe Systems, Inc., Apple, Inc., Google, Inc., Intel Corporation, Intuit, Inc., and Pixar ("Adobe")*, stated that these agreements were *per se* violations of Section 1 of the Sherman Act that "disrupted the normal price-setting mechanisms that apply in the labor setting." DOJ was solely concerned with market power that the defendants might exercise as buyers of labor and did not allege any effects in output markets.

The economic analysis of buyer market power is very similar to the analysis of seller market power. A firm that is the only buyer in a relevant antitrust market for an input is called a monopsonist. A monopsonist can influence the price it pays for an input, such as labor, by changing the amount that it buys. Just as a monopolist restricts output to increase price, a monopsonist restricts the number of workers hired to reduce wages. While a competitive firm will hire workers until the price of labor (wages and benefits) equals the marginal value of an additional worker, a monopsonist would hire workers until the marginal labor cost equals the marginal value of an additional worker. The marginal labor cost is greater than the price of labor, because by raising its price to hire additional workers the monopsonist increases the price it must pay all workers. The monopsonist thus pays workers less than their marginal value and hires fewer workers than a competitive firm would, just as a monopolist charges buyers higher prices and produces less output than a competitive firm. Monopsony results not only in a transfer of wealth from labor to the firm, but also in economic inefficiency due to the lower quantity of labor hired.

If labor does not have market power, the lower wages a monopsonist pays do not result in lower output prices because the monopsonist bases its output decisions on the higher marginal cost of labor, not the wage. Output prices may be competitive, for example, when the monopsonist competes with other firms (perhaps in other geographic areas) who face competitive input markets. Because the firms with monopsony power no longer employ the optimal quantity of labor, however, economic inefficiency can occur even if output prices are competitive.

Since the effects of buyer market power on economic efficiency depend on the reduction in labor purchases, it is important to examine whether such reductions occur. In *Adobe*, DOJ did not discuss the effect of the agreement on the number of workers hired. Monopsony may not cause economic inefficiency under certain conditions, such as bilateral monopoly, which exists when a market with only one buyer also has only one seller. Bilateral monopoly can eliminate the effect of monopsony on the quantity purchased, as the FTC found in *Caremark Rx, Inc./AdvancePCS*. The FTC declined to challenge that 2004 merger because it did not find that the acquisition would lower overall purchases. The *2010 Horizontal Merger Guidelines ("2010 Guidelines")*, however, indicate that the Antitrust Agencies do not require a short-run effect on quantities purchased to indicate that a merger will increase buyer market power.

The *2010 Guidelines* provide more detail about mergers that are likely to enhance buyer market power than did the 1992 *Horizontal Merger Guidelines*. While the *Adobe* case was not a merger, the issues that the *2010 Guidelines* describe are relevant to the consideration of buyer market power in that case. First, the *2010 Guidelines* explain that the relevant market would include alternatives available to sellers in the face of a decrease in the price paid by a hypothetical monopsonist. Buyer market power may exist in a local area because inputs, such as labor, cannot easily move to other areas. Some of the employees in the *Adobe* case are employed by firms with locations in the Silicon Valley. If Silicon Valley employees could easily relocate, that would limit Silicon Valley firms' ability to exercise buyer market power.

continued on page 4

Dodd-Frank Financial Reform

continued from page 2

corporations and the Federal Reserve. For example, modified loan covenants may help protect against changes in corporate strategy that would favor newly empowered stockholders at the expense of lenders. Such protections could facilitate a mutually beneficial decrease in the cost of capital. Various hedging strategies may also be productively revisited with an eye toward increased inflationary pressures on monetary policy.

Finally, proxy advisors may benefit from considering the new law's risks. Dodd-Frank's easing of proxy access, for example, may broaden the interests that compete for consideration from boards, thus weakening the stability of corporate policy. And both the Act's "Say on Pay" and its easing of proxy access may turn *de jure* non-binding votes into *de facto* binding votes, thereby changing how management bargains with potential dissidents.

The Dodd-Frank Act has created risks in at least two ways that are important for professionals in organizational planning, risk management and proxy advising. First, the Act reshapes the Fed in a way that may institutionalize a more accommodative stance on inflationary monetary policy. Second, it strengthens the voice of shareholders in a way that may benefit shareholders at the expense of other corporate stakeholders rather than improve business performance more generally. Businesses should gauge exposure to these risks before they are realized and develop strategies in anticipation of how the numerous rule-making processes and judicial reviews that will follow the Act can further reshape the non-market environment in which businesses must operate. More generally, professionals in law, finance and business can benefit from appreciating the economic fundamentals that give rise to non-market risks, an appreciation that can help them develop productive strategies to succeed in a rapidly evolving institutional environment.

The *Adobe* Case

continued from page 3

Second, the *2010 Guidelines* recognize that monopsony can have anticompetitive effects even in cases where there are no downstream effects. This concept is not new. For example, in a predatory monopsony case, *Weyerhaeuser Co. v. Ross-Simmons Hardwood Lumber Co.*, the Supreme Court recognized that a predatory monopsonist could potentially recoup its losses in the input market and would not necessarily raise prices in the output market. In *Adobe*, the competitive impact statement refers only to the effect on competition for high tech employees. No mention is made of any effect in output markets. In fact, the *Adobe* defendants do not compete in the same output markets.

Finally, the 2010 *Guidelines* discuss efficiencies in buyer arrangements, such as those that may lower "transactions costs or allow a firm to take advantage of volume-based discounts." In a case under Sherman Section 1, the effects of an agreement that has procompetitive benefits that are an intrinsic part of the collaboration are analyzed under the rule of reason. In *Adobe*, DOJ rejected the rule of reason by arguing that the agreements had no intrinsic benefits. Had the case been litigated, the defendants might have argued that the agreements were needed to realize significant efficiencies. The defendants might also have argued that the agreements had a negligible, if any, anticompetitive effect, as they limited only one method by which workers learn of employment opportunities. Google stated in its "Public Policy Blog" that options for potential employees include LinkedIn, job fairs, employee referrals, and direct contact. The measurement of the effect of the "no call" agreement on both wages and employment levels would have been an important issue.

In summary, when investigating a matter involving buyer market power, the Agencies consider the options available to suppliers and any efficiencies from the merger or agreements being considered, but do not necessarily consider effects in the downstream market. Had the *Adobe* case gone to trial, these principles likely would have been applied to the arguments on both sides of the case.

EI News and Notes

Economic Analysis of the Regulation of MVPD Navigation Devices

A report by EI Senior Vice President Michael G. Baumann and Vice President John M. Gale on the economics of multichannel video programming distributor (MVPD) navigation devices (set-top boxes) was filed with the Federal Communications Commission (FCC). The FCC expressed concern that the limited retail market for set-top boxes may indicate market failure. The report explains why most consumers prefer to lease set-top boxes from their MVPD rather than purchase the devices from retailers and shows that the low demand for retail set-top boxes does not indicate market failure. The report also discusses problems with the FCC's proposal to require all MVPDs to provide an adapter, called an AllVid device, to connect proprietary MVPD networks to new televisions and other video devices via a standard interface.

Video Games in the 21st Century: The 2010 Report

EI Principal Stephen Siwek wrote *Video Games in the 21st Century: The 2010 Report*. The report, which was prepared for the Entertainment Software Association, updates and expands upon an earlier study that quantified, for the first time, the economic benefits provided by the entertainment software industry to the U.S. economy as a whole. The 2010 Report includes statistical data through 2009.

Travel Center Merger

Pilot Travel Centers and Flying J completed a merger to form Pilot Flying J, a network of over 550 travel centers operating in 43 states. Before the merger, Pilot operated 275 U.S. locations. Flying J had filed for bankruptcy protection in 2009. The Federal Trade Commission (FTC) approved the transaction after Pilot Flying J agreed to sell 26 locations to Love's Travel Stops & Country Stores. The FTC staff had considered the impact of the merger in a provisional market of travel centers with a national presence. EI Chairman Barry C. Harris and EI Senior Vice President Michael G. Baumann worked with White & Case and Kirkland & Ellis on the matter.

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