ECONOMICS COMMITTEE NEWSLETTER

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Welcome

It is our pleasure to welcome you to the summer 2016 edition of the Economics Committee Newsletter. The newsletter aims to provide a forum where Section of Antitrust Law and Economics Committee members can share their views on topics related to the relationship of antitrust law and economics worldwide.

In this edition of the newsletter, we include five summaries of seminars and panels held since last December and sponsored by the Economics Committee. Professor Massimo Motta, Chief Competition Economist at DG Competition in the European Commission gave a telephone seminar on his personal views on the relationship between competition policy and fairness. Dr. Patrick DeGraba, Economist at the Federal Trade Commission's Bureau of Economics, provided his insights on the fundamentals of market definition in the framework of the Fundamentals of Antitrust Economics Series. Alden Abbott, Bill Markovits and Professor Daniel Crane discussed the merits and implications of the Sixth Circuit's *Collins Inkjet Corp. v. Eastman Kodak Co.* Decision. A panel of four economists moderated by Hillary Burchuk discussed economic issues raised by recent attempts of Comcast Corporation to merge with Time Warner Cable Inc. in the telecommunications industry. Finally, Dr. Jeffrey Prisbrey gave a presentation on the fundamentals of unilateral effects theories in horizontal mergers in the context of Fundamentals of Antitrust Economics series.

The summer 2016 edition of the newsletter also includes summaries of three of the four Spring Meeting panels held in Washington, DC, between April 6-8, 2016 and sponsored by the Economics Committee: the session on Economics Fundamentals, the panel discussion on Presenting Economic Evidence in Merger Trials, and the panel discussion on Price War: Reconciling Conflicting National Pricing Restraints.

The newsletter is intended to provoke discussion. As a result, the opinions expressed are only those of the authors and not necessarily those of the American Bar Association, the Section of Antitrust Law, the Economics Committee or its subcommittees or any other individuals or entities.

We hope that you enjoy the newsletter!

Kind Regards

Matthew Hall (McGuireWoods LLP, Brussels) and Cani Fernández (Cuatrecasas Gonçalves Pereira SLP, Madrid), Co-editors.

Call for Articles

We are always looking for articles for future issues of the Economics Committee Newsletter. If you have an article or an idea for an article regarding the current or potential future use of economics in analyzing issues of antitrust law worldwide, please share it with us.

Contact Matthew Hall at mhall@mcguirewoods.com or Cani Fernández at cani.fernandez@cuatrecasas.com for more information.

Economics Committee Programming Since the Spring Meeting

The Economics Committee has put on several programmes since the 2016 Spring Meeting in Washington, D.C.:

- A Networking Reception and Discussion with Nancy L. Rose, Deputy Assistant Attorney General for Economic Analysis, U.S. Department of Justice, July 7, 2016.

- A Session on Econometrics in the Fundamentals of Antitrust Economics Series, with Dr. Laila Haider, Edgeworth Economics, July 1, 2016.

- A Session on Vertical and Coordinated Effects in the Fundamentals of Antitrust Economics Series, with Dr. Debra Aron, Navigant Economics, May 27, 2016.

- A Session on Unilateral Effects in the Fundamentals of Antitrust Economics Series, with Jeffrey Prisbrey, Vice President at Charles River Associates, April 28, 2016 (summarized in this Newsletter).

Transcripts of all Economics Committee programmes are available on its website and on Section of Antitrust Law "Connect".

Summary of Panel Discussion: Implications of the Sixth Circuit's *Collins Inkjet Corp. v. Eastman Kodak Co.* Decision[1]

Speakers:

Alden Abbott, Heritage Foundation

Daniel Crane, University of Michigan

Bill Markovits, Markovits, Stock & DeMarco, LLC (counsel for plaintiff/appellee)

Moderator: *Suzanne Wahl*, Schiff Hardin

Sponsor: American Bar Association, Section of Antitrust Law, Price and Conduct Committee

Date: December 11, 2015

On December 11, 2015, the ABA Section of Antitrust Law held a panel discussion entitled Implications of the Sixth Circuit's *Collins Inkjet Corp. v. Eastman Kodak* Decision, sponsored by the ABA Section of Antitrust Law's Price and Conduct Committee. The discussion was moderated by Suzanne Wahl, an associate at Schiff Hardin in Ann Arbor, and speakers included Alden Abbott, Professor Daniel Crane, and Bill Markovits.

The discussion centered on the Sixth Circuit's decision earlier this year that addressed the standard for assessing coercion in a Section 1 tying case when that coercion is allegedly accomplished via the offering of a lower bundled price. Unlike any other appellate court, the Sixth Circuit in Collins applied the discount-attribution test first adopted by the Ninth Circuit in its PeaceHealth decision under Section 2 of the Sherman Act. This panel debated the merits and implications of the Sixth Circuit's decision, which upheld a preliminary injunction enjoining the tie.

PANELISTS:

Alden Abbott became the Rumpel Senior Legal Fellow and Deputy Director of the Nice Center for Legal and Judicial Studies at the Heritage Foundation in April 2014. He previously served as Director of Patent Antitrust

[1] This summary has been prepared by Erik Raven-Hansen, an antitrust associate in the Washington, D.C. office of Allen & Overy LLP.

Strategy for Blackberry, and in a variety of senior government positions, including Associate Director of the Federal Trade Commission's Bureau of Competition, Acting General Counsel of the U.S. Commerce Department, Chief Counsel for the National Telecommunications and Information Administration, and Senior Counsel, Office of Legal Counsel at the U.S. Department of Justice. Alden is also an adjunct professor at the George Mason Law School, a member of the leadership in the American Bar Association's Antitrust Section, and a non-governmental advisor to the International Competition Network. He lectures and publishes on antitrust law and law economics, and is a regular contributor to Truth on the Market, a leading website specializing in antitrust and regulation.

Professor Daniel Crane is Associate Dean for Faculty and Research at the Fredrick Paul Furth Senior Professor of Law at the University of Michigan. He is the author of six books on antitrust law, including The Institutional Structure of Antitrust Enforcement and The Making of Competition Policy with Herbert Hovenkamp. Professor Crane has written extensively on loyalty discounts and related questions of monopolization in law and economics.

Bill Markovits is the founding member of the law firm of Markovits, Stock & DeMarco, LLC in Cincinnati Ohio. Bill's career has focused on antitrust litigation for over thirty years, first as a trial attorney at DOJ's Antitrust Division in Washington D.C., and later as an adjunct professor of antitrust law at the University of Cincinnati Law School and antitrust litigator. He's been involved in a number of antitrust cases, including a class action in Cincinnati on behalf of physicians that resulted in a jury award of over $100m dollars, and a national class action against Microsoft, where Bill was chosen among plaintiffs' attorneys to depose Bill Gates. Bill was also the lead plaintiffs' attorney for Collins in the *Collins Inkjet Corp. v. Eastman Kodak*, the subject of the panel's discussion.

LEGAL LANDSCAPE:

Professor Crane began the discussion by providing brief background comments on the legal context of this decision. The Collins decision lies at the intersection of two long-term trends in antitrust law governing exclusionary practices: tying law and unilateral price-discounting law. In tying law, the last several years have seen a continuation of the courts' gradual retreat from the once-prevalent view that tying arrangements have little purpose other to suppress competition. Crane explained that this view has been thoroughly debunked as a matter of economics, and it has been well understood for decades that tying can have many associated procompetitive justifications or efficiencies,

and that efforts to leverage monopoly power through tying will often be unsuccessful over time because there can only be one monopoly profit extracted from complementary goods.

He added that although there are many different views about the implications for consumer welfare and economic efficiency, we have retreated from the heyday where tying was viewed as per se illegal and pernicious, and economic understanding has evolved such that courts are now less hostile towards tying. Cases in the last several decades that contributed to this trend include Jefferson Parish,[2] the D.C. Circuit's Microsoft decision,[3] and the Supreme Court's Independent Ink decision.[4] Even the Supreme Court's decision in the Kodak case in 1992[5] moved the law further towards economic analysis. In the words of Judge Diane Wood in the Seventh Circuit, "[t]oday the Supreme Court takes a much more benign view of tying, recognizing that it may be procompetitive or competitively neutral and thus that it should be illegal only if there is sufficient power in the tying market to restrain competition in the market for the tied product. . . . Antitrust law has backed away from the flat condemnation of tying arrangements because they are not always abusive and when they are not, they are legitimate method of competition."[6]

Crane noted that the other intersecting line of cases illustrate the Supreme Court's growing solicitude towards unilateral pricing mechanisms arising out of the Supreme Court's predatory pricing jurisprudence – cases like Matsushita,[7] Cargill,[8] and in particular, Brooke Group.[9] Courts have displayed a growing willingness to apply some version of a price-cost test, and only condemn pricing structures that result in below-cost pricing, other than in traditional unilateral single-product predatory pricing cases. For example, the price-cost test has been applied to bundled discounts in the Ninth Circuit's PeaceHealth decision.[10]

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[2] *Jefferson Parish Hospital Dist. No. 2 v. Hyde*, 466 U.S. 2 (1984).

[3] *U.S. v. Microsoft Corp.*, 253 F. 3d 34 (D.C. Cir. 2001).

[4] *Illinois Tool Works Inc. v. Independent Ink, Inc.*, 547 U.S. 28 (2006).

[5] *Eastman Kodak Co. v. Image Technical Services, Inc.*, 504 U.S. 451 (1992).

[6] *Batson v. Live Nation Entertainment, Inc.*, 746 F.3d 827, 831 (7th Cir. 2014) (internal citations and quotations omitted).

[7] *Matsushita Elec. Industrial Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

[8] *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104 (1986).

[9] *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

[10] *Cascade Health Solutions v. PeaceHealth*, 515 F.3d 883 (9th Cir. 2008).

Crane explained that the extent to which the courts should apply the price-cost test remains an open question. In the Collins case, the court asked when is a conditional discount on a purchase of one product so coercive that it amounts to tying. In Crane's opinion, this question has to be answered with reference to a price-cost test. As the Supreme Court recognized in Jefferson Parish, an element of forcing or coercion is necessary to a tying claim. A conditional discount that does not prevent a competitor from competing for the tied product, because the competitor or rival can profitably offer its own discount in response, is not a coercive tie.

FACTUAL BACKGROUND:

With that introduction, Alden Abbott and Bill Markovits then explained the factual underpinning in Collins. They explained that Kodak manufactured a line of commercial printers under the trade name Versamark. It stopped manufacturing these in 2009, though the useful life of the printers was generally 10-20 years. By 2009 there was a large installed base of over 1000 customers of Versamark printers. This led to two primary sources of after-market revenue; (i) sales of a component called a print head which had to be periodically replaced on the printers and which was manufactured solely by Kodak; and (ii) sales of specialized ink that was necessary for use in the Versamark printers. Collins Inkjet was a small ink manufacturer whose primary product was the ink for Versamark printers, a chief competitor of Kodak's in the ink market (and the only competitor for over 20 years). Through 2001, Collins gained about 50% of the market for Versamark ink. Then from 2001 to 2012, Collins and Kodak had a series of supply and reseller agreements under which Collins produced its own Versamark ink, but it also produced Versamark ink that was branded with the Kodak label, thus a large percentage of Kodak ink was actually produced by Collins.

When Collins terminated that agreement in July 2013, Kodak reacted with a pricing scheme that raised the cost of replacing Versamark print heads for only those customers who were using non-Kodak ink. Abbott explained that this harks back to the 1992 Supreme Court Kodak case, which focused on the idea of antitrust after-markets. Once a customer is locked in to a printer purchase, the after-market theory treats the relevant market as the installed base, or customers of that particular branded printer, and thus contracts by the firm from whose product was purchased which try to drive out alternative providers of services are anticompetitive. Criticism of this theory often attacks the single-minded focus on

an after-market, and the related neglect of ex ante competition for printer purchases in the first instance.

PROCEDURAL BACKGROUND:

Markovits reviewed the procedural posture of the case, which began when Collins filed suit alleging that this practice amounted to an illegal tying arrangement, prohibited per Section 1 of the Sherman Act. After expedited discovery and a bench trial in the Southern District of Ohio, the district court issued a preliminary injunction prohibiting the differential pricing scheme, and applying a standard for non-explicit tying or non-contractual tying, which asked in part whether all rational buyers of the tied product would be forced to purchase it from Kodak.

Kodak appealed, and on appeal they argued that the discount-attribution test set forth in PeaceHealth in the Ninth Circuit (a form of a price-cost test) should apply; notably, Kodak argued for the first time on appeal that the Ninth Circuit's test in PeaceHealth was applied to bundling, rather than the tying allegations in Collins.

Markovits noted that the Sixth Circuit agreed that a price-cost test should be applied, and that they should apply the discount-attribution test that was used in PeaceHealth for bundling, but with a difference. Collins argued on appeal for PeaceHealth's discount-attribution test using the plaintiffs' cost – not the defendants' cost – which was novel. The Sixth Circuit rejected that argument, holding that the price-cost test should use the defendant's cost. Based on that standard, the Sixth Circuit still affirmed the preliminary injunction, finding from the evidence that it was likely that the plaintiff would be able to show that Kodak was pricing below cost under the PeaceHealth test. Kodak then petitioned for certiorari, and argued again on petition for application of a discount-attribution test or a price-cost test using plaintiffs' cost. Before that could be decided, the case settled.

CASE ANALYSIS:

Discussion then turned to the existing case law on tying and unilateral pricing. Crane commented that he viewed the case law in light of the mechanism of exclusion, and that where you have a contractually-based mechanism of exclusion, the analysis differs than that for a price-discount based mechanism. For example, where a supplier tells the customer that they must purchase X, Y or Z from the supplier (as the dominant firm), or requires the customer to buy the

tied product from the supplier if the customer wants the tying product – and that requirement is specified contractually or as a hard condition of dealing – then the mechanism of exclusion is contractual, and there's no need to discuss the price-cost test. Take the Third Circuit's Dentsply case, where Dentply as the dominant supplier of teeth for dental labs had adopted a policy of requiring distributors to be exclusive to its line in order for the distributor to carry any Dentsply teeth. Crane commented that there is no need to review the price-cost test there, because price is not the factor excluding competition. Rather, a contractual term prohibits the customer from doing business with a rival, and in order to deal with the rival, the customer would actually have to breach the contract.

Crane compared that to a price-term exclusive mechanism, often a contingent or conditional price term. There, a dominant firm would require the customer to display a certain kind of loyalty (such as buying two different products or buying a certain market share amount), and will then lower a customer's price as compared to the price in the absence of that loyalty. In those cases, a customer can still buy from the rival without breaching a contract, and the only consequence for a rival purchase is that the customer will pay a higher price to the dominant firm for whatever they may buy. Crane continued to note that the question then arises as to whether the rival can profitably make up for the lost discount without the rival having to price below cost. If that's the case, and the rival is able to offer a discount that neutralizes the effect of the dominant firms' conditional discount and does not have to do so unprofitably to itself, then there isn't any foreclosure nor exclusion and there is no harm to competition. Crane added that the goal of the price-discount test, like the PeaceHealth modified discount-attribution test, is to look for whether there's objective economic evidence that the rival was unable to compete on price because responding to the dominant firm's discount structure would force the rival to price below its cost. Crane believes that the Collins court was correct that there shouldn't be any foreclosure in the tied market without a threshold showing that the contingent pricing-discount structure resulted in a price that the rival could not profitably match.

Abbott added that in his opinion, the PeaceHealth test applied in the bundling context was missing some key components. He noted that in response to Brooke Group, the Antitrust Modernization Commission stated that in a tying case where pricing is a matter of exclusion, you should have a recoupment standard, and should also ask if the bundled discount, rebate program, or tying program has had or is likely to have an adverse effect on competition. One should ascertain not only whether the firm will be able to change it's pricing after

driving another firm out of the market, but also whether there are other firms who would choose not to enter. In Collins, under the PeaceHealth test, it was left an open question as to whether Kodak would have been able to recoup its losses, and whether there were potential entrants. Crane read PeaceHealth differently, as once the rival suffers an inability to compete for a customer's business because the price after discount-attribution is below cost, the court must ask whether there is substantial foreclosure in the tied market, or an actual anticompetitive effect suppressing competition. He believes that once you satisfy the PeaceHealth screen and prove that there is coercion and foreclosure, there's still a question about whether the degree of that coercion or foreclosure in a properly defined relevant market is great enough that there is a harm to competition in that market. Abbott disagreed in turn, noting that the per se nature of the tying rule prevented the Collins opinion from this threshold approach. Even if PeaceHealth set out the sophisticated threshold approach, Abbott expressed uncertainty whether the less sophisticated courts elsewhere recognize it.

In Markovits' opinion, this ties into the question of whether or not this should be viewed as a discount or a penalty, and the related implications of that choice. PeaceHealth applied the discount-attribution test to bundling, but refused to apply it to tying. The Antitrust Modernization Commission suggested a discount-attribution test should be applied towards bundling, but stated that it was not recommending application of that test outside of the bundling context, such as in tying or exclusive dealing cases. Markovits believes that here, the conduct amounted to a penalty. Kodak determined it had to take action or it was going to lose customers. The action it determined to take was not to compete on the merits, not to discount prices, but to impose a penalty on the refurbishment costs that were being charged to customers who decided to use Collins Ink. That's important because there's no profit sacrifice: Kodak is increasing the penalty for customers who decide to use Collins Ink. He added that it's difficult to think how Sixth Circuit would even consider recoupment in that context, because there was no short-term loss; unlike in a single-product predatory pricing case, Kodak did not have to lose any profits or suffer any short-term loss by the pricing policy they invoked.

Markovits does not agree with the application of the discount-attribution test in a case of this nature. Collins' customers were faced with a choice: if they stayed with Collins they had to pay a relatively huge penalty that Kodak was imposing on refurbishment, and refurbishment costs that were generally in excess of ink cost on an annual basis. In some cases, the refurbishment penalty exceeded the cost of the ink. Clearly, under any attribution test, Kodak would have failed.

He added that even if the penalty was not greater than the cost of the ink, the real world implications show it remains exclusionary: if Collins discounted their own price to compete, Kodak could simply lower its price further and repeat the scenario. He added that Kodak's documents produced in discovery recognized that Collins Ink was generally cheaper, superior, and had better customer service, thus forcing consumers to switch was detrimental to consumer welfare. Crane disagreed with the distinction between penalty and discount, arguing it amounts to semantics. He added that as to the absence of profit sacrifice, if Kodak is already charging the profit-maximizing monopoly price before it institutes this so-called penalty, by definition the penalty involves profit sacrifice; an onerous economic condition or term in a contract is equivalent to a price increase from an economic perspective. In his view, it's not impossible that you could use this price structure to exclude competition, but it does entail profit sacrifice.

RELEVANT MARKET AND SUBSTANTIAL FORECLOSURE:

The panelists next discussed the issue of the relevant market as an after-market. In Abbott's view, whether the after-market should be considered as relevant market is part of the broader issue of ascertaining the effect on competition as opposed to that on the individual competitor. The problem with an after-market analysis is that it ignores the fact that there is a very competitive market for printers, and that Kodak's contractual principles may drive sophisticated buyers to consider alternatives: a market defined by particular brand of product ignores the broader competitive dynamics. Abbott added that in this case, we really don't know whether the conduct was exclusionary. The framework first assesses whether there is market power in the tying product, and here, by definition of the after-market, there is market power; second it assesses whether there's a substantial amount of commerce displaced in the tied market. Under this framework, courts can look at orthodox old Supreme Court case law and find a per se violation. He advocated a three-pronged approach instead: first, a court should look at the language of the D.C. Circuit regarding platform ties, which held that these issues are too new and complicated to adopt a per se rule. Second, the agencies' 1995 IP guidelines are instructive, which assess an IP tie by asking whether the arrangement has an adverse effect on competition in a relevant market for the tied product. Third, courts should consider whether there are there efficiency justifications for the arrangement that outweigh the anticompetitive effects. Here, he added that Collins is stuck in a per se framework: we don't really know whether there would have been other entrants to the Kodak-related ink market; we don't know whether Collins Ink would have survived; and we don't know the ultimate effects on end-consumers without the

use of market analysis. Markovits added that in the district court briefs and appellate briefs, both in terms of the proposed findings of fact and conclusions of law, there was relatively little argument about the existence of an after-market in this case. Kodak didn't argue the point too strongly, focusing instead on the argument that there was no illegal exclusionary activity.

Crane then addressed the issue of substantial foreclosure. He believes the question should be what the tying effects are in the tied market: if a bundled discount structure results in foreclosure under the price-cost test, meaning that the competitor is unable to compete for some of the business in the tied market, and that the degree of foreclosure so significant that it actually harms competition. If under the discount-attribution test at least some portion of the tied market is foreclosed to rivals, then the question becomes whether the un-foreclosed portion of the market allows rivals a realistic chance of achieving minimum viable scale. Markovits stated that in Collins it was a question of the degree of foreclosure: for some customers the annual refurbishment penalty exceeded the price of the ink, thus Collins is foreclosed from those customers or that portion of the market. He added that there were other customers where the refurbishment penalty was not as drastic, where it might have been possible for Collins to discount and remain about an average variable cost, but it remains a question of scale and whether Collins could proceed with the few customers they could have retained, while knowing that Kodak could simply increase the penalty and foreclose those customers as well. Concerning the application of the PeaceHealth test in Collins, Markovits noted that the proof offered in the footnotes shows that Sixth Circuit examined pricing "below cost," instead of examining average variable costs as required by the PeaceHealth test, but that appropriate analysis would show pricing below average variable cost as well.

For final thoughts, Markovits stated that this imposes another hurdle for plaintiffs bringing an antitrust case, and that the cost of econometric analysis may make an antitrust claim for most plaintiffs cost-prohibitive. Crane noted that Collins straddles the reform of tying law, away from the historical per se hostility, while recognizing the importance of price-discounting tests. Abbott observed that substantial confusion persists on tying, and that this remains an area that would benefit from the Supreme Court's guidance. All agreed that they hoped coming decisions would flesh out these issues.

Summary of Session on Market Definition in the Fundamentals of Antitrust Economics Series[1]

Guest Speaker: *Patrick DeGraba*, Economist at the Federal Trade Commission's Bureau of Economics.

Moderator: *Donald K. Stockdale*, Bates White

Sponsor: American Bar Association, Section of Antitrust Law, Economics Committee

Date: December 14, 2015

On December 14, 2015, Dr. Patrick DeGraba graciously gave the first presentation to the American Bar Association Section of Antitrust Law in a series titled Fundamentals of Antitrust Economics, providing his insights specifically on the fundamentals of market definition. Dr. DeGraba currently works as an Economist at the Federal Trade Commission (FTC). Prior to joining the FTC, Dr. DeGraba served as Deputy Chief Economist of the Federal Communications Commission (FCC) and later returned on detail from the FTC as Chief Economist in the FCC's Wireless Bureau, where he made significant contributions to reforming the FCC's approach to defining telecommunications markets. Dr. DeGraba earned a PhD in Economics from the University of Pennsylvania, and taught as an Assistant Professor in the Johnson Graduate School of Management at Cornell University.

Dr. DeGraba began the presentation by explaining the importance of market definition in conducting a merger analysis. When analyzing mergers, the ultimate goal is to identify competitive effects of the transaction and determine whether the combination would either create market power or allow market power to be exercised by the merging parties. Dr. DeGraba stated that defining the relevant market often serves as the starting point for a merger investigation, and is ultimately an exercise in identifying all those products that are close substitutes for the products under analysis in the merger. For example, if two luxury carmakers sought to merge, one would want to identify all vehicle models produced by other carmakers that might be good substitute options for purchasers of models of the merging parties if the car prices offered by the merging parties increased.

[1] This summary has been prepared by Daniel K. Oakes, Associate at Axinn, Veltrop & Harkrider LLP.

Dr. DeGraba explained that the term "market definition" (a term originally invented by attorneys rather than economists) is unfortunate and somewhat misleading because it suggests the existence of a highly specific "market" that, if one simply looked hard enough for, would have a determinable scope with clear metes and bounds. This idea has led to what Dr. DeGraba views as an unfortunate overreliance by many decision makers (including agencies and judges) on "market definition" in approaching mergers. Dr. DeGraba said that the antitrust world might have been better served if a more appropriate term had taken root, such as "substitutes triage" or "likely competing product delineation," which would reflect the idea that a market definition ought not be treated as sacrosanct, but rather as a list of products that should be considered for analyzing competitive effects. In the first instance, market definition should be an overly inclusive first approximation of close substitutes so that one does not incorrectly eliminate at the beginning of the investigation products that might constrain the merging parties.

While he believes it is often overused as a determinant of the propriety of a proposed transaction, Dr. DeGraba stated that market definition analysis can be useful for estimating measures of market concentration, such as by calculating the Herfindahl–Hirschman Index, which is the sum of the square of the share of each competitor in the market. This exercise requires a determination of the set of firms and products that compete "in the market." Such calculations achieve best results with commodity products and either high concentration or low concentration markets.

However, Dr. DeGraba warned that there are several potential pitfalls in relying on market definition for analyzing a merger. First, market concentration is only one indicator of likely competitive harm, and the Horizontal Merger Guidelines state that the "analysis need not start with market definition." Dr. DeGraba taught that a better indicator of potential competitive harm would be an examination of how closely the merging firms compete against each other, and whether there is direct evidence of a likely effect on price when the firms merge. If competitive effects can be demonstrated, then market definition is not even necessary. Second, not all potentially competing firms have equivalent competitive significance, so even when a competitor can be appropriately included in a market, this does not mean that its shares should necessarily be attributed full value.

Dr. DeGraba stated that the essential goal of the market definition analysis is to identify all the products to which many or most customers might switch if

the prices of the products of the merging parties under investigation were to increase. Under the Horizontal Merger Guidelines, there are two dimensions on which the market must be defined. The first is the product market dimension, which includes all the attributes of the product and contemplates customers' willingness to substitute among products with different characteristics. Second is the geographic market, which involves either the customer or supplier location. Dr. DeGraba said that the geographic scope of the market is nothing more than an attribute of the product. The geographic element receives special focus in the analysis because it has proven useful in many cases, though it is not material to a given case.

Dr. DeGraba then discussed the method for defining a market outlined in the merger guidelines—The Hypothetical Monopolist Test. This test begins by creating a candidate market that includes a narrow set of products, normally a single product sold by each of the merging firms. One then must ask whether a hypothetical monopolist that controls this market could profitably impose a "small but significant and nontransitory" increase in price (or "SSNIP", a price increase of 5-10%) above the benchmark level, most often the current prevailing price. (The Hypothetical Monopolist Test is also referred to as the "SSNIP Test").

Dr. DeGraba said that if one assumes that the combined company imposes a SSNIP, one of two things would happen. First, profits on the products in the candidate market could increase above the pre-SSNIP levels, indicating that customers facing the SSNIP do not have sufficient alternative substitutes to turn to in order to defeat the price increase. In this circumstance, the products in the proposed product market constitute a relevant product market and there is no need to conduct additional iterations of the analysis. Second, if the price change is not profitable, then the price increase would have driven customers away from the products in the candidate product market and toward other substitute products. In this circumstance, one would then expand the candidate market by adding the product to which the most sales are diverted, and then conduct the analysis again to see whether a SSNIP would be profitable as applied to the new candidate market.

To illustrate the Hypothetical Monopolist Test, Mr. DeGraba proposed a hypothetical merger between Mercedes and BMW, for which the FTC may question whether German luxury cars constitutes a relevant product market. One would start with a candidate market including only German luxury cars, and ask whether a SSNIP on all those cars would be profitable. Mr. DeGraba stated

that if a hypothetical monopolist were to raise the price by 5%, presumably, some of the customers would purchase some other type of car (e.g., a Japanese or American luxury car, or other non-luxury cars). If we observed that the profit of German luxury automakers decreases, we would likely find that people purchased other types of luxury cars instead. In that case, we would include other luxury cars in the market and try the SSNIP Test again. If the SSNIP were profitable, then luxury cars would be considered a relevant antitrust market.

Dr. DeGraba warned that the SSNIP Test tends to be over-inclusive because, in practice, when the prices of products in the candidate market increase, the prices of their substitutes (in equilibrium) will also increase. However, the SSNIP Test assumes that the price of substitutes remains unchanged. Thus, if substitutes are not able to attract enough customers to defeat a price increase by the hypothetical monopolist when the prices of the substitutes are held constant, these substitutes would be even less of a competitive constraint if their prices changed in response to the candidate market products. In this way, the SSNIP Test overstates the competitive constraint a substitute will impose if its price is allowed to adjust.

Dr. DeGraba taught that when prices are increased on the products in the candidate market, two things will occur. First, some customers will shift their purchases to substitute products and thus some unit sales will be lost. Second, the price increase that applies to the remaining sales of products in the candidate market (to customers that have not switched away) would result in increased revenues. The relevant question for the SSNIP Test is which one of these effects is dominant, the increased profits on the remaining sales or the lost profits from lost unit sales.

Dr. DeGraba explained that the first part of SSNIP Test is finding the "Critical Loss", or the number of lost units that allows a hypothetical monopolist to break even (i.e., such that the lost profit from those lost sales just equals the increase in profits from the remaining sales). The percentage Critical Loss is equal to the percentage change increase in price (normally for a SSNIP around 5%) divided by the sum of the margin on a unit sale of the product plus and the percentage change increase in price. In general, the larger a company's margin, the smaller the critical loss percentage would be on a SSNIP because the company would stand to lose more money per unit sale that is lost. This calculation is depicted below.

$$\%CL = \frac{\%\Delta p}{M + \%\Delta p}$$

The second part of the SSNIP Test requires actual estimation of the "Predicted Loss" (also called the "Actual Loss"), or the number of lost unit sales that the hypothetical monopolist is predicted to lose due to the price increase. If the Predicted Loss from the SSNIP is less than the Critical Loss, the SSNIP is predicted to raise the hypothetical monopolist's profits, and the hypothetical product market would in fact constitute a relevant product market. Reliable estimation of the Predicted Loss is a crucial step in the analysis, and Predicted Loss is most often calculated with the help of economists who can estimate diversion among products and price effects. The ability to conduct a reliable SSNIP analysis is often predicated on the availability of appropriate data, which can be gathered through interviews with market participants, gained through depositions, or found in documents including a company's business and marketing plans, bidding data, sales reports, internal or third party industry studies, or other internal documents like emails. The SSNIP analysis by itself is rarely dispositive, and courts look to see that SSNIP Test results are consistent with other evidence of market definition.

As an example, Dr. DeGraba discussed the 2003 proposed merger of super premium ice cream makers Nestle and Dreyer's. In that case, the question faced by the FTC was whether super-premium ice cream formed a relevant market by itself or whether other ice creams or frozen desserts should also be included in the relevant market. In that case, the FTC examined retail data and observed that when Dreyer's entered the market with its Häagen-Dazs super-premium brand, the price of super-premium ice creams decreased, but the prices of regular premium brands were largely unaffected, suggesting that super-premium ice cream formed its own relevant market. Retail data also allowed for the calculation of diversion ratios between super-premium and premium ice cream.

Dr. DeGraba highlighted an inherent tension in a merger defendant's claim that very high margins lead to both a low critical loss and a high predicted loss. To produce the most favorable SSNIP Test results, merging parties often argue that they have very high margins (making a low Critical Loss) and many substitute products exist (making a high Predicted Loss). However, Dr. DeGraba warned that, while high margins do suggest a low Critical Loss by the formula described above, high margins also indicate that price elasticity (or the ability of customers to switch) is low, which would generate a low Predicted Loss.

Dr. DeGraba then discussed the treatment of targeted customers, which he believes to be the most important part of the Horizontal Merger Guidelines. Under the targeted customer theory, a set of products sold to an identifiable group of customers can constitute a separate market if: (1) the seller can price discriminate and charge that group of customers a different price than other customers; and (2) arbitrage is not possible between the group of targeted customers and other customers.

Dr. DeGraba discussed the FTC's recent victory in Sysco/US Foods as an illustration of the targeted customer theory. In that case, the two largest (and only) broadline food distributors with a national footprint sought to merge in a deal that would have effected a merger-to-monopoly from the perspective of national customers who required one-stop shopping from a single distribution service. The FTC argued that national customers would not switch their purchases from the merging parties to a patchwork of smaller regional distribution services in response to a SSNIP by Sysco/US Foods. Because national customers normally purchased on company specific terms through an RFP system, Sysco and US Foods possessed the ability to price discriminate and customers could not engage in arbitrage. The FTC's economic expert analyzed internal bidding, RFP and sales data and concluded that the Critical Loss was around 50% and the Predicted Loss was lower than 50%, thus the broadline services to the group of targeted national customers was in fact a relevant market. In such cases, Dr. DeGraba stated that the targeted customer analysis for market definition is similar to a competitive effects analysis.

Dr. DeGraba also highlighted the FTC's challenge of the attempted merger of Whole Foods and Wild Oats, the two largest organic grocery chains in the United States, as another example of a targeted customer case. The FTC defined the relevant market as Premium Natural Organic Stores, but defendants argued that the market was broad enough to encompass all stores that sold food, including conventional supermarkets, gourmet stores, and club stores. The District Court found that antitrust harm would be unlikely because there at least some marginal customers would switch from Premium Natural Organic Stores to other stores in response to a SSNIP. However, the FTC presented data showing that when Whole Foods entered competition with Wild Oats, both Wild Oats' prices and margins decreased more than when faced with entry by any other type of merchant. Moreover, the core customers of Premium Natural Organic Stores primarily bought perishable goods, and Whole Foods and Wild Oats competed closely for those customers, and could price discriminate against them. The D.C. Circuit found that the District Court had incorrectly defined the market, and that

the cluster of organic goods they purchased at Whole Foods and Wild Oats constituted a submarket.

Summary of Session with the Chief Competition Economist, European Commission, DG Competition[1]

Guest speaker: *Professor Massimo Motta*, Chief Competition Economist, European Commission, DG Competition

Moderators: *Janet L. McDavid*, Hogan Lovells and *Kristina Nordlander*, Sidley Austin

Sponsor: American Bar Association, Section of Antitrust Law, Economics Committee

Subject: Competition and Fairness

Date: January 11, 2016

Professor Massimo Motta (MM), Chief Competition Economist of the European Commission, DG Competition (Directorate-General for Competition) shared some of his personal views on the relationship between competition policy and fairness and then took questions from the moderators and audience. He said that his views are personal and do not necessarily represent those of DG Competition or of the European Commission.

MM started his remarks with a consideration of the objectives of competition policy. There is a broad consensus nowadays that competition policy is about efficiency (or seeking to produce the maximum level of consumer or total welfare). It is not about social or political objectives.

However, in the EU some lawyers and judges probably think otherwise and there is also a "market integration" objective which applies in the EU. This is unique to the EU and is not easily understood from an efficiency perspective. It serves a different objective. In other jurisdictions, there may be public interest objectives written into the competition law rules. For example, this is the case in South Africa.

"Fairness" is sometimes aligned with efficiency and sometimes in conflict with efficiency and the idea of fierce competition.

[1] Summary prepared by Matthew Hall, Solicitor (England & Wales/Ireland), McGuireWoods LLP, Brussels and Vice Chair, ABA Section of Antitrust Law, Economics Committee

The concept of fairness is however vague. It can generally be considered as similar to equality or equity or an absence of discrimination. It may be related to process, conduct or outcomes. Fairness towards consumers or buyers may be equated with outcome fairness, something that from the legal point of view is controlled for example by rules against exploitative practices or excessive pricing by dominant companies, consumer protection laws or the rules against cartels. Fairness towards rivals may be equated with process fairness, which from the legal point of view is controlled for example by rules against exclusionary practices by dominant companies or unfair trading/unfair competition laws.

Fairness may also refer to equality in market outcomes (which MM referred to as ex post fairness), which is inconsistent with the concepts of efficiency and strong competition since in a market there are always winners and losers. Competition policy does not expect outcome fairness of this type.

MM then considered how to reconcile fairness and efficiency. In his view, the focus should be on ex ante fairness, which means guaranteeing a level-playing field and that each firm can compete in and contest the market (this is really process fairness). This requires the elimination of administrative barriers to entry and having well-operating financial and labour markets, amongst other matters. It also means ensuring that dominant firms cannot limit the entry or expansion of rivals. Competition law can play a role at least in relation to controlling state aid (so that particular companies do not gain an unfair advantage from state interference) and control of abuse of dominance.

This is process fairness and it is what matters. It is also consistent with economic efficiency, since competition promotes productivity growth (as shown by the economic literature). Competition policy is really about this; how to facilitate entry and exit so as to increase productivity growth. Most productivity growth is down to the selection process between competing firms.

Ex post fairness (or fairness in outcomes, certainly equality of outcomes) will not necessarily follow, since exit may well occur if a firm is unsuccessful. By contrast, if fairness is looked at from the ex ante point of view, then fairness can be reconciled with more efficiency and growth (although seeking ex post fairness through rules such as control of excessive prices is not inconsistent with efficiency principles).

MM then fielded a number of questions from the moderators and the audience. The first question concerned how closely fairness is linked to the

market integration objective of EU competition law. Are we likely to see a single and narrower goal of economic efficiency once the market integration objective is seen as substantially achieved? MM said that in his view it is not correct to equate market integration with fairness. Market integration is by and large interpreted as requiring companies not to price discriminate between countries in the EU or, to be more precise, not to use clauses that impede parallel trade. The issue is therefore price discrimination.

However, there is nothing in the literature which says that price discrimination is bad for welfare. It may increase welfare or decrease it, so the market integration objective does not coincide with efficiency objectives.

In discussing this issue, MM asked the audience to consider what is unfair about price discrimination. Price discrimination brings higher prices for rich consumers and lower prices for poor consumers, whereas suppressing it brings lowers prices for rich consumers and higher prices for poor consumers. Alternatively, suppressing price discrimination may just mean that poor consumers are not served at all. Practical examples of the tension between fairness and market integration rules arise in the pharmaceutical sector, for example.

The second question concerned the powers available to competition law regulators so as to seek to achieve ex ante fairness. Given that enforcement typically takes place after an infringement has occurred and when the playing field may already have tilted, should they have more powers available to them? MM said that there is certainly room for public policies that seek to guarantee free entry. He is in favour of public bodies taking a more active role to guarantee this. An example is enforcement of the EU state aid provisions, which is a way of correcting market failures. Market inquiries are another good example (such as carried out by the UK Competition and Markets Authority). These allow for shaping of the market on an ex ante basis. Advocacy by regulators is also important, in particular so that legislators focus on the correct rules to put in place which lead towards fairness.

The next question concerned the role of the Chief Competition Economist. MM said that the job consists of two different, and sometimes not wholly-aligned, roles: director of economic analysis for DG Competition's case work; and a scrutiny or checks-and-balances role providing independent economics advice to the EU Competition Commissioner. The incumbent has to interpret the position with these two roles in mind. MM has focused on the scrutiny role so operates

with a light-touch in relation to the case team work. He ensures that the teams choose the correct theories of harm and then tries to ensure that the facts fit the theories. This is a personal interpretation of the role.

MM further said that the "Devil's Advocate" panels are part of the internal DG Competition checks and balances system. The system is an administrative one, so appropriate internal steps need to be taken. There is also the European Commission's Legal Service and the Oral Hearing held before the independent Hearing Officer. His view is that these various procedures do make decisions more robust.

The audience then asked several questions. The topics covered included the treatment of mergers that produce positive consumer welfare benefits in some geographic areas but negative in others and the treatment of abuse of dominance cases in the EU. On the latter issue, MM said that the EU takes a much more interventionist approach than does the U.S. This is at least partly because in the U.S. it is possible to rely more on market forces whereas in the EU markets are much less free. There is generally less financing and higher barriers to entry overall in the EU. However, the analysis of dominance cases in the EU is not satisfactory. There is more room for an effects-based analysis in the EU and future cases (particularly at the General Court) should take this on board. The European Commission has adopted an effects-based approach, while to some extent the court has not.

An audience member asked for MM's views on the ongoing debate about the impact of telecom mergers on investment. He said that mergers generally do not lead to an increase in investment. The literature shows instead that competition gives rise to investment and that more investment does not arise from less competition. Efficiency gains can always be argued but they need to be justified by reference to the standard tests set out in the case law and guidance (the efficiencies have to benefit consumers, be merger-specific and be verifiable).

Summary of Panel Discussion: Economic Issues Raised in the Comcast - Time-Warner Cable Merger[1]

Speakers:

Dr. Joseph Farrell, Professor of Economics at University of California Berkeley, and Partner at Bates White Economic Consulting. For the Comcast – Time Warner transaction, he appeared on behalf of Cogent Communications.

Dr. Nicholas Hill, Assistant Section Chief of the Economic Analysis Group at the Department of Justice's Antitrust Division. For the Comcast – Time Warner transaction, he managed the Economic Analysis Group's economic staff working on the case.

Dr. Mark Israel, Executive Vice President at Compass Lexecon. For the Comcast – Time Warner transaction, he appeared on behalf of Comcast.

Dr. William Rogerson, Charles E. and Emma H. Morrison Professor of Economics at Northwestern University. For the Comcast – Time Warner transaction, he was the FCC's senior economist.

Moderator: *Hillary Burchuk*, Assistant Bureau Chief for Competition in the Enforcement Bureau of the Federal Communications Commission.

Sponsor: American Bar Association, Section of Antitrust Law, Economics Committee.

Date: February 8th 2016

Dr. Donald Stockdale, co-chair of the Economics Committee of the Antitrust Section of the American Bar Association (henceforth abbreviated as ABA), started the event by thanking the host – Charles River Associates – and introducing the panel discussion's moderator, Hillary Burchuk – Assistant Bureau Chief for Competition in the Enforcement Bureau of the Federal Communications Commission (henceforth abbreviated as FCC).

The moderator (Ms. Burchuk) then introduced the four panelists, each an economist that provided an opinion to some party during the Comcast – Time Warner attempted merger transaction. The four panelists are:

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[1] This summary has been prepared by Scott D. Gilbert, Ph. D., Associate Professor of Economics at Southern Illinois University Carbondale.

Dr. Joseph Farrell, Professor of Economics at University of California Berkeley, and Partner at Bates White Economic Consulting. For the Comcast – Time Warner transaction, he appeared on behalf of Cogent Communications.

Dr. Nicholas Hill, Assistant Section Chief of the Economic Analysis Group at the Department of Justice's Antitrust Division. For the Comcast – Time Warner transaction, he managed the Economic Analysis Group's economic staff working on the case.

Dr. Mark Israel, Executive Vice President at Compass Lexecon. For the Comcast – Time Warner transaction, he appeared on behalf of Comcast.

Dr. William Rogerson, Charles E. and Emma H. Morrison Professor of Economics at Northwestern University. For the Comcast – Time Warner transaction, he was the FCC's senior economist.

The moderator outlined the planned event, in which three of the economists (Drs. Farrell, Hill, and Rogerson) would speak on specific topics, with an invitation to Dr. Israel to rebut their remarks, followed by a question and answer session with the audience.

To start the discussion, the moderator briefly described the Comcast – Time Warner transaction.

Description of Comcast – Time Warner transaction

In February 2014, Comcast – the nation's largest cable company and internet service provider (ISP) – announced it would acquire Time Warner – the nation's second largest cable provider, fourth largest multichannel video programming distributor (MVPD), and third largest ISP. By April 2014, Comcast and Charter Communications entered a series of transactions, and as a result, post-merger Comcast would have had about 60% of U.S. high-speed broadband subscribers, significantly expanding its market presence.

The Comcast – Time Warner transaction involved two kinds of asset combinations: distribution assets (cable video + internet) plus programming assets – including Comcast's NBC Universal programming. The main concern about the merger centered on the horizontal combination of distribution assets, rather than the vertical combination of programming and distribution assets. In terms of the combination of cable assets, there was a lack of horizontal geographic overlap, but that was not end of the story.

Many of the views and material submitted by economists on the Comcast – Time Warner transaction remain confidential, and this limits the range of remarks in today's panel discussion.

It's helpful to recall changes in video programming delivery, at the time of the merger transaction. First, there were changes in way consumers could get video programming delivery, with the arrival of online viewing via online video distributors (OVDs), such as Dish's Sling and streaming services by HBO and CBS. Second, and related to the first point, there was an increased importance of high-speed broadband connection for viewing programs. To succeed, OVDs need to deliver content to customers online via high speed broadband, without hindrance by data caps that would limit the amount of content delivered.

The moderator then asked for remarks by Dr. Rogerson, senior economist for the FCC in the Comcast – Time Warner transaction.

William Rogerson

Dr. Rogerson began his remarks with four initial observations. First, the Comcast – Time Warner merger proposal potentially involved two kinds of combinations of assets: horizontal and vertical. The horizontal combination involved merging regionally non-overlapping telecommunication distribution assets, while the vertical combination involved Comcast's programming assets which would combine with the distribution assets of Time Warner. However, the core theories of harm for the merger attempt lay principally with the horizontal combination. Second, the transaction would have significantly increased Comcast's share of both MVPD subscribers and broadband subscribers at the national level. Third, the fact that the horizontal combination would not involve much regional overlap suggests that the merger would not decrease retail customer competition, in which case any harm from the merger must come from some other source. Fourth, the emergence of online video distributors (OVDs), with smaller bundles of programming or innovative features such as Dish's Sling service, promised to introduce new competition into video distribution markets and was a desirable development for consumers but potentially threatened the business models of existing facilities-based MVPDs.

Dr. Rogerson then outlined a theory of harm for the Comcast – Time Warner merger transaction. This is that although Comcast and TWC operate in local markets at the retail level, they also operate in two national markets as providers of "eyeballs" to programmers and OVDs seeking national distribution

of their products. The increase in market shares at the national level would create both an increased ability and incentive for the merged entity to take actions that would disadvantage OVDs and thus depress or discourage the development of a vibrant and competitive OVD sector. In particular, OVDs need two key inputs: last mile broadband interconnection to consumers and programming. The transaction would increase both Comcast's ability and incentive to take actions to limit OVD's access to these inputs. The theory includes three sub-theories. First, increased market share and size as a retail broadband provider would increase Comcast's bargaining power in interconnection negotiations, giving it the ability it to charge higher interconnection fees for broadband service. Second, its larger size as an MVPD would create more bargaining power when buying programming and increase its ability to negotiate terms with programmers that could lessen programming available to others – including OVDs. Third, increased size would create an increased incentive to take actions that would disadvantage OVDs, reflecting internalized positive externalities between Comcast and Time Warner that result from such actions.

To summarize the core theory of harm, the merger would increase Comcast's share of the nation's broadband and MVPD subscribers, and so increase Comcast's ability and incentive to disadvantage OVDs.

The moderator then asked for rebuttal remarks by Dr. Israel – economist for Comcast in the Comcast – Time Warner transaction.

Mark Israel

In his rebuttal remarks, Dr. Israel noted – as Dr. Rogerson did earlier – that the lack of regional overlap in Comcast and Time Warner programming distribution suggested that the horizontal combination of the two companies' distribution assets was not obviously a problem from the standpoint of economic theory, leaving the question of whether there were any competitive concerns as an empirical one. He then described some theories of harm that merger opponents raised during the investigation (not his own views).

First, one might have suggested that the merger of the companies as buyers of programming content could allow the combined company to act as a monopsony (e.g., sole buyer) when negotiating with content providers, but this theory did not get developed or advanced much in the actual case against the merger.

Another point is that Comcast and Time Warner provide different inputs to content providers, via their distinct regional coverage, and these inputs could be viewed as complements or substitutes – from an economic standpoint. But this theory also was not developed in the case, and the main debate focused mainly on bargaining theory.

There is also the foreclosure doctrine/theory whereby the vertical combination of firm assets may create incentive to enrich the upstream part of the business – programming content – by leveraging control of the downstream part of the business – programming distribution. But this economic theory is problematic, as both the costs and benefits of increasing the upstream business would scale up with the merger, making it unclear how the merger could increase foreclosure incentives.

Further, any anticompetitive effects of increase scale of size of the merged companies, via a big footprint theory, seem unclear and may in any case be offset or overshadowed by efficiencies associated with larger scale. That is, to the extent there is a "big footprint" theory for foreclosure, Dr. Israel argued there is at least as compelling a big footprint theory for efficiencies, yet the FCC gave these little credit.

The moderator then asked for responses from other panelists.

William Rogerson

First, Dr. Rogerson agreed that it was an empirical issue whether larger MVPDs and broadband providers had more bargaining power. Do larger broadband providers charge higher interconnection fees? Is there a danger in non-price terms, restricting OVDs, if the MVPDs merge? Lacking a clear economic theory, the answers to these questions are an empirical issue, and that's how they were approached in the case.

Second, on the point of whether the merger would create an incentive to disadvantage OVDs, this too was an empirical issue to some extent. In the case, documents from companies were examined, and data allowed one to calculate different profit margins, departure rates, etc., and analytically determine what was in the companies' interest.

The moderator then asked for remarks by Dr. Joseph Farrell, economist for Cogent Communications in the Comcast – Time Warner transaction.

Joseph Farrell

Dr. Farrell first noted that when you evaluate a concern that a firm will disadvantage one of its products in order to promote or protect another – such as disadvantaging an OVD – it is not enough to compare margins on the different products. You must also gauge how big the erosion and promotion effects are. For instance, how much impact will such a strategy have on Comcast MVPD and broadband subscribership? For a profit-maximizing firm, margins chosen by the firm tells us a lot about firms' perception of demand responses. Just because one margin is higher than another doesn't say whether a company will take a particular action to promote one product versus the other.

The case was only partly about OVDs being able to operate over a Comcast network. It was also partly about a big long-term issue in the industry: having appropriate entry conditions for overbuilders competing with broadband providers. Some broadband providers might operate with exclusionary provisions in contracts with program providers, and there are incentives for that increase with size, as Dr. Rogerson pointed out, and with the strength of the competitive threat.

The moderator then asked for remarks by Dr. Nicholas Hill, economist for the Department of Justice in the Comcast – Time Warner transaction.

Nicholas Hill

Dr. Hill briefly discussed some of the empirical work that the Department of Justice (abbreviated DOJ) did on the Comcast – Time Warner transaction. The DOJ did a range of analyses, two of which focused on programming fees and interconnection fees, respectively, and their connection with the size of MVPDs and ISPs.

Since, as Dr. Israel pointed out, the theory on the relationship between size and bargaining leverage is ambiguous, the DOJ wanted to see what the empirical evidence showed.

In terms of programming fees, the focus was on the relationship between per-subscriber (abbreviated per-sub) fees – paid by MVPDs to programmers for channels – and the size of MVPDs. Based on contract data for MVPDs and programmers, there were more than 500+ observations in the sample.

Based on input from the industry, and the data, three things seem to have a big impact on per-sub programming fees: the size of the MVPD – hence its leverage, the quality of the programmer's content/channel, and the timing of the contract – with prices rising over time.

The DOJ ran many regressions involving per-sub programming fees and the size of MVPDs. The variable of greatest interest was the number of subscribers to the MVPD that had access to the programmer's channel. There were controls for channel quality, the effective date of the contract, and distribution quality. The finding was that as the number of subscribers goes up, per-sub fees go down in a manner that is statistically significant and economically important. A possible explanation is a volume discount, but additional evidence suggested otherwise.

On the whole, the programming fee analysis suggested that the merger would allow Comcast to pay lower fees for programming content, while significantly increasing Comcast's subscribership – by about 30 percent. The increased size, or scale, would have created a leverage effect, providing more leverage to get lower per-sub fee and/or to restrict the ability of OVDs to compete.

The interconnection fee analysis focused on the relationship between fees and ISP size, based on data from major ISPs and content providers, with over 50 data observations in the sample. The study controlled for the size of ISP, contract date, and contract type (pay for capacity or for usage), and other factors, and found a robust relationship: larger ISPs charged significantly higher interconnection fees. The study also controlled for quality of ISP (speed, data per subscriber). The core relationship held up, suggesting that the merger would significantly increase fees charged, and cause harm to OVDs.

Overall, conclusions of the study are that a merger resulting in a larger MVPD or ISP would lead to more leverage, enabling Comcast and Time Warner to harm OVDs.

The moderator then asked for rebuttal remarks by Dr. Israel.

Mark Israel:

Dr. Israel noted that he had not had full access to the research provided by the DOJ, and he suggested that more exchange of information among economists involved in such cases would be a good idea generally. He then remarked that the

empirical questions underlying the DOJ work were important and also difficult – owing in part to the possible endogeneity of a key factor, the size of the MSVP or ISP. There is some reason why MVPs and ISPs have they subscribers that they do, but this may be something endogenous (for example, higher quality MVPDs might both have more subscribers and be able to charge higher prices), and while the DOJ tried to control for enough confounding variables, better would be a natural experiment or an instrument like a previous merger.

To illustrate the difficulties in drawing conclusions from empirical observations, Dr. Israel notes that content providers get revenue from MVPDs and from ads, and since larger MVPDs are better at getting advertising revenue, content providers may be willing to accept lower fees from larger MVPDs in exchange for more ad revenue, not necessarily reflecting bargaining power of MVPDs.

In term of economic harm, even if one accepts the DOJ results as given, a key fact is that, on the MVPD side, larger MVPDs pay lower prices for content, pushing price down toward marginal cost, increasing economic efficiency and consumer benefit. While increasing size of MVPDs may harm content providers, in theory, there seems to be less evidence for that. Specifically, interconnection fees seem quite low, even tiny, and it's unclear that they would get significantly bigger with size.

The moderator then invited a response by Dr. Hill.

Nicholas Hill

Dr. Hill said that he agreed with Dr. Israel that more engagement among economists on other sides of merger cases would be good. He also agreed that ads are an important issue, and that while the DOJ tried to control for them, efforts were imperfect. He also agreed that low per-sub fees might pass through and so benefit consumers, and that this is a relevant consideration, in addition to OVD harm, when examining the merger transaction. On the point of low interconnection fees, he acknowledged that low fees are true today, but that they would likely grow rapidly.

The moderator then invited responses by other panelists.

William Rogerson

Dr. Rogerson indicated that he agreed with the remarks of the last two speakers, and pointed out that the FCC – like the DOJ – did its own independent analysis, as thorough and complete as that of the DOJ.

The moderator then questioned Dr. Israel's claim that programmers were willing to accept lower programming fees from Comcast because the programmers could earn more in advertising revenues due to Comcast's advanced advertising platforms. The moderator pointed out that the record showed that pre-merger these advanced platforms were not fully developed, and could not be the source of the extra revenue. Dr. Israel stated that these platforms would be more dynamic after merger, and generate more revenue. Dr. Israel also responded that his analysis nevertheless supported a link between ad revenue and size – higher for Comcast than other MVPDs.

The moderator then invited remarks by Dr. Farrell, on how theory and empirics diverge.

Joseph Farrell

Dr. Farrell notes that if an intermediate player – such as an interconnection provider – gets better prices for inputs, with nothing else changing, they will to some extent be passed through to the consumer. But with an increase in bargaining power for an intermediary, one might expect harm to customers on both sides, and thus to consumers overall. He states that he thinks the latter approach is right, but that it is a difficult issue to resolve, and his client (Cogent) did not have resources – financial or informational – to facilitate a study that could resolve it. As a supporting fact, he notes that if size effects are actually beneficial and are passed through to consumers, and if efficiencies of size are important, then large cable companies should be able to attract customers away from smaller ones, and customers of small companies should be agitating to get served by large companies, neither of which seems to happen much.

If a lack of geographic overlap is an exogenous fact, then an increase in size has an effect that most people, except economists, would consider obvious: size increases bargaining power. In the economics literature, he noted that relationship between size and price – while not necessarily causal – broadly confirms that size tends to confer bargaining power. It remains difficult to know how much one can extrapolate from published studies to the Comcast – Time Warner transaction. Theory suggests that a key question is: is the payoff

function – from getting access to more subscribers – convex or concave? It may depend on the content provider and intermediary. This makes it hard to do anything, and makes it challenging to extrapolate.

Dr. Farrell stated that he thinks that policy should not be paralyzed by unavoidable ambiguity. A possibility is to do a closely related study, as described by Dr. Hill. Empirically, the balance of evidence seems to suggest that increased scale leads to additional bargaining power. He also noted that theoretical ambiguity is not new to economics, and he illustrated the point via the economic theory of expected utility – wherein the utility function can be concave or convex, the former shape being pragmatically sensible.

The moderator then invited a rebuttal response from Dr. Israel.

Mark Israel

Dr. Israel said that, while the panelists have been discussing a merger analysis of firms with non-overlapping retail, a more traditional merger study would not have taken a correlation to imply that size causes price. Hence we should be careful about accepting size/price correlations in this context. He also noted that economists are sure of many things that other people reject, such as the claim that businesses should ignore sunk costs when making decisions.

He also emphasized that the competitive effect of the proposed merger – good or bad – would have depended on whether the relevant goods are viewed as substitutes or complements. If a content provider has distribution from either Comcast or Time Warner, getting the other may become less valuable, or more valuable, after merger. He cautions against generalizing from findings from other industries, again noting a need to know if the relevant goods are complement or substitutes. Increasing scale may involve complements, and a merger may create downward pressure on prices, which is good for consumers.

The moderator then invited questions from audience.

The first question was about size and interconnection fees, and whether there was a jump or discontinuity in how fees related to size. In response, Dr. Hill indicated that the DOJ examined a variety of functional forms for the fee-size relationship, allowing for instances of zero fees, and Dr. Israel followed up by noting that any size effect may be discontinuous, with zero or small fee situations occurring for small or intermediate ISPs.

The second question was whether there was any substantive difference between the conclusions that FCC and DOJ drew about the Comcast – Time Warner deal. Ms. Burchuk replied that the two agencies coordinated closely, and there was not much daylight between the two positions.

The third question was: why was there no effort to remedy possible merger downsides – such as increased interconnection fees – via conditions imposed on merger? Ms. Burchuk said that the agencies went through the process of sharing concerns with the parties, and the parties then abandoned the transaction, so ending discussion.

The fourth question was theoretical, and addressed the logical consistency of the economic contract theories that the panelists had discussed. Dr. Israel noted that the economics of the industry includes some imperfections, including the fact that content providers charge MVPDs per-customer for content even though marginal cost may be zero, and that there is value to more study of these imperfections. Dr. Farrell noted that, in terms of a dominant firm crafting contracts with input suppliers, the joint value from exclusionary terms depends on a number of things – as shown in the vertical constraints literature – but more power from bargaining raises the prospect of ending up with something having more exclusion or restriction.

Spring Meeting Program – Summary of Session on Economics Fundamentals[1]

Speakers:

Dr. Nicholas Hill, Asst. Section Chief (Economic Analysis Group), Antitrust Division, U.S. Department of Justice, Washington, DC

Dr. Debra J. Aron, Managing Director, Navigant Economics, Chicago, IL

Dr. Keith J. Brand, Economist, Federal Trade Commission, Washington, DC

Dr. Paola Valenti, Columbia University, New York, NY

Moderator: *Donald K. Stockdale*, Bates White

Sponsor: American Bar Association, Section of Antitrust Law, Economics Committee

Subject: Market Definition, Market Power, Competitive Effects and Econometrics.

Date: April 6, 2016

Market Definition: *Dr. Nicholas Hill*, Asst. Section Chief (Economic Analysis Group), Antitrust Division, U.S. Department of Justice, Washington, DC

Dr. Hill began by defining several basic concepts related to market definition. He first defined "price elasticity" as the percentage change in demand resulting from a percentage change in price. He defined the related concept of the "cross-price elasticity of demand" the sensitivity of the demand for one product to changes in the price of a substitute product. Dr. Hill distinguished two types of products: "homogeneous products," which he described as essentially "commodities," in which each producer makes a substantively identical product (e.g. milk, soybeans); and "differentiated products," which are products that have distinct characteristics that set them off from similar products (e.g. beer or soda).

Dr. Hill then discussed the reasons why relevant markets are defined. First, market definition identifies both the line of commerce and the part of the country

[1] This summary has been prepared by Justin D. Kingsolver, Associate at Crowell & Moring LLP, Washington, DC .

that could be impacted by a deal. Second, market definition identifies the relevant competitors and defines those competitors' market shares: this creates a framework for modeling the competitive effects of a proposed transaction.

Dr. Hill also discussed the methods that economists use to define markets. The dominant method, he stated, is the "Hypothetical Monopolist Paradigm," which asks whether, if one firm controlled a set of products, that firm would impose "at least a small but significant and non-transitory increase in price ('SSNIP")" on at least one product in the market (including at least one product sold by one of the merging firms). If the answer is yes, under this approach, the set of products is a market. If the answer is no, more products must be added before the group of products can be tested again to see whether they constitute a market.

Market definition, Dr. Hill explained, is concerned with consumer substitution, both product and geographic substitution. Using the example of a hypothetical merger between Coke and Pepsi, Dr. Hill asked whether, if the price of Coke rose, would consumers switch to Pepsi, private label colas, sparkling waters, or other kinds of beverages. He explained that economists and lawyers who are trying to define this market must ask which products considered are likely close substitutes. He explained the concept of recapture by noting that pre-merger, customers lost by Coke to Pepsi harm Coke, but under the hypothetical monopolist paradigm, those sale are not lost, but rather recaptured by Pepsi. If the recapture is sufficiently high (i.e., if a more expensive Coke leads a sufficient number of consumers to buy Pepsi), then at hypothetical price increase would likely be profitable and the two products would be deemed to comprise a market.

Market Power: *Dr. Debra J. Aron*, Managing Director, Navigant Economics, Chicago, IL

Dr. Aron discussed issues of market power. She began her presentation by discussing Adam Smith's classic "Invisible Hand" theorem and the model of a perfectly competitive market, in which, under certain circumstances, the interplay of firms and consumers, acting in their own self-interest, result in an allocation of resources that collectively maximizes (static) social welfare. Market power, Dr. Aron suggested, disrupts that social welfare maximizing outcome. Antitrust law seeks to constrain firms' activities that would materially reduce social welfare by impeding the competitive process.

Citing Landes and Posner, Dr. Aron defined "market power" as "the ability of a firm or group of firms within a market to profitably charge prices above the competitive level for a sustained period of time." Dr. Aron then discussed the conditions under which a competitive market will maximize social welfare. These conditions include the following:

1. There are enough firms in the market such that each firm's output is negligible in relation to the total market output.
2. Products are homogeneous. The only differentiator between products in the eyes of consumers is price.
3. Consumers have perfect information.
4. New entrants face no barriers to entry.

Dr. Aron next discussed the effects of market power. She explained that a profit-maximizing firm with market power will set price above marginal cost, which will result in a loss of consumers and producers surplus. This is known as the deadweight loss associated with monopoly. She went on to explain that real markets generally are not perfectly competitive nor purely monopolistic. Rather all firms have some degree of market power. She further explained that society also values innovativeness or "dynamic" efficiency, and that it will sometime encourage dynamic efficiency by protecting market power at the possible expense of static efficiency, as when it grants patent monopolies.

Finally, Dr. Aron identified a number of measures of market power, including concentration rations, the Herfindahl-Hirschman Index, and the Lerner Index, but noted that there is no single universally accepted and accurate measure of market power.

Competitive Effects: *Dr. Keith J. Brand*, Economist, Federal Trade Commission, Washington, DC

Dr. Brand described two types of competitive effects: unilateral and coordinated. Unilateral effects involve changes to the internal strategic incentives of the individual firm after, and as a result of, the merger. Coordinated effects involve whether a transaction will make it more or less likely that merged firm and its competitors will coordinate to thwart competition.

Dr. Brand focused his talk on unilateral effects in differentiated products markets, which he explained competitive effects through a sample competitive model involving a classic two-firm oligopoly in which the firms sell similar but differentiated profits (e.g., Coke and Pepsi). In a perfectly competitive market, these firms choose their price to maximize their individual profits, which yields a competitive equilibrium in the market. Were these two firms to merge, the incentives facing the newly-merged firm could change. In particular, the firm could have an incentive increase prices to supracompetitive levels an increase in the price of one of its products (say Coke) would lead to an increase in demand and profits of the second product (Pepsi). Specifically, the firm would set the price of good 1 so that the marginal revenue from good 1 equals the marginal cost of good 1 plus the diversion rate from good one to good 2 times the margin on good 2.That post-merger firm may also experience new opportunities to cartelize the market.

Dr. Brand noted there are several methods economists use to measure competitive effects. He discussed both net pricing pressure and the Gross Upward Pricing Pressure Index ("GUPPI"). He explained that analyzing pricing pressure can be a useful tool, because, among other things, data are often available, they are easy to evaluate and understand, and this approach does not require a priori market definition. He noted, however, that such an approach does not account for the possibility of post-transaction new entrants or industry repositioning to mitigate competitive effects. He further noted that this "first order" analysis may give false negative, due to feedback effects. For example, he noted that, if pre-merger margins are low primarily because of competition that will be eliminated by the merger, then the formula may underestimate the price effects of the merger. Dr. Brand concluded by discussing other models that exist to measure competitive effects, including bilateral bargaining models and models to evaluate auction bidding.

Econometrics: *Dr. Paola Valenti*, Columbia University, New York, NY

Dr. Valenti defined "econometrics" as "the application of statistics to economics." She explained that econometrics could be used to answer questions related to market definition and market power, merger analysis, class certification, and the calculation of damages.

She then went on to discuss "regression analysis," which she defined as a statistical tool "to model the relationship between a dependent variable and one or more explanatory variables." She suggested this tool could be used to examine a

theoretical relationship between almost any variables, including, for example, ice cream sales v. temperature, wages v. education level, or price v. cost.

Dr. Valenti went on to explain regression analysis using a hypothetical data set she created that contained data on the price of barley and the price of fertilizer. She went on to explain how one could interpret the results of a regression analysis, including explaining the constant term, the coefficients on the independent variable, the error term, the confidence interval, the p-value, and the $R2$. Dr. Valenti then showed how regression analysis could be used to then used to estimate damages caused by a hypothetical conspiracy among brewing companies to fix the price of barley. Using regression analysis with a dummy variable for the period of the conspiracy, Dr. Valenti showed how one could estimate damages caused by the conspiracy.

Dr. Valenti concluded by discussing some of the potential issues associated with econometric analysis, including problems caused by poor or missing data, problems caused by omitted variables, difficulties in distinguishing between correlation and causation, and problems associated with spurious correlation.

Spring Meeting Program – Summary of Panel Discussion: Presenting Economic Evidence in Merger Trials[1]

Speakers:

Timothy F. Bresnahan, Stanford University, Department of Economics, Palo Alto, CA

Stephen A. Mohr, Federal Trade Commission, Washington, DC

Mark A. Israel, Compass Lexecon, Washington, DC

Daniel M. Wall, Latham & Watkins LLP, San Francisco, CA

Chair and Moderator: Ian Simmons, O'Melveny & Myers LLP, Washington, DC

Sponsor: American Bar Association, Section of Antitrust Law, Economics, Mergers & Acquisitions, and Trial Practice Committees

Date: April 6, 2016

Background

The topic of discussion was how "the outcome of merger trials can turn on the resolution of conflicting economic testimony and whether that testimony is intelligible and consistent with a recognized theory of harm and the record 'facts.'"[2] Market definition and price discrimination, in particular, were to be discussed. Four of the five participants were protagonists in the recent Sysco Corp.–US Foods merger trial.[3] Prof. Bresnahan and Dr. Israel were economic experts for the defense and the Federal Trade Commission (FTC), respectively. Mr. Simmons defended Sysco while Mr. Mohr was trial attorney for the FTC.

What Is the Role of Economic Experts in Merger Trials?

[1] Summary prepared by Rainer Schwabe, Associate at Cornerstone Research's New York office. The views expressed in this article are solely those of the author, who is responsible for the content, and do not necessarily reflect the views of Cornerstone Research.
[2] Agenda, ABA Spring Meeting 2016, at 9.
[3] Federal Trade Commission et al. v. Sysco Corporation et al., No. 1:15-cv-00256 (*Sysco*).

Mr. Mohr was first to speak, noting that economic analysis touches most, if not all, elements of the DOJ/FTC Merger Guidelines.[4] Yet, in spite of the central role that complex economic analysis can play in merger trials, simpler and more qualitative principles can be persuasive to a court. The recent decision in the Sysco–US Foods merger, for instance, found the Brown Shoe Practical Indicia probative.[5]

Mr. Wall began his comments by paying tribute to the late Tom Rosch by saying, "I learned or stole all I have to say on this from Tom."[6] According to Mr. Wall, an economic expert must contextualize what is unique about a merger situation. It is the expert's job to bring together the data, industry analyst commentary, and the customer and competitor testimony, and show how they fit into the economic story of the merger. From the defense perspective, this amounts to teaching the judge how rigorous antitrust analysis applies to the situation at hand. This education of the court is essential to overcoming the government's initial advantage, conferred by the perception that enforcers' primary objective is to protect consumer welfare.

There are many challenges that may arise in a merger trial that can be overcome by effective testimony from an economic expert. The market in question may be concentrated, but economic analysis can show that the importance of market structure is not definitive.[7] Bad documents may arise, such as incriminating e-mails, but may be proven toothless in the broader context of the industry. Similarly, customer complaints are easy to come by. An expert economist must put this type of superficially damning evidence into context and educate the judge on how it can be incorporated into, and reconciled with, rigorous economic analysis. That is, the expert must convince the judge that evaluating each piece of evidence in a merger is complicated.

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[4] U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (2010) (hereafter "Merger Guidelines"), *available at* https://www.justice.gov/atr/horizontal-merger-guidelines-08192010.

[5] Memorandum Opinion, *Federal Trade Commission et al. v. Sysco Corporation et al.*, at 23-28. ("According to Brown Shoe, '[t]he boundaries of [a product market] may be determined by examining such practical indicia as industry or public recognition…, the product's peculiar characteristics and uses, unique production facilities, distinct customers, distinct prices, sensitivity to price changes, and specialized vendors.' Brown Shoe, 370 U.S. at 325. 'These indicia seem to be evidentiary proxies for direct proof of substitutability.' Rothery Storage & Van Co. v. Atlas Van Lines, Inc., 792 F.2d 210, 218 (D.C. Cir. 1986); H&R Block, 833 F. Supp. 2d at 51.")

[6] J. Thomas Rosch, distinguished partner in Latham and Watkins' antitrust practice and Commissioner of the FTC from 2006 to 2013, passed away on March 30, 2016. For an overview of his career, *see* https://www.lw.com/news/in-memoriam-of-tom-rosch.

[7] "Mergers that cause a significant increase in concentration and result in highly concentrated markets are presumed to be likely to enhance market power, but this presumption can be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power." Merger Guidelines, §2.1.3.

In these ways, economists are the "stars of mergers"—they are the first to go beyond the facts of the case by presenting a formal analysis of the evidence.

Dr. Israel built on Mr. Wall's points, emphasizing the importance of avoiding technical lingo when presenting economic analysis and educating the court. Some jargon is needed—it is not practical to speak of differentiated products or diversion without appealing to the technical terms. But, for the most part, jargon can be avoided—rather than speaking of cross-elasticities of demand, one can refer to customer substitution among products. Experience teaching MBA and undergraduate students is useful as it forces the expert to explain economic concepts in non-technical terms.

The biggest risk an economic expert faces is getting lost in the trees; it is easy to lose sight of the overarching question one is trying to address when focused on explaining specific and complex analyses. For that reason, it is important that the expert clearly define the question he or she is addressing. For example, when defining the relevant market, one is specifying the set of firms, products, and competitors that constrain price. In order to do this, a useful thought exercise is to think of when the set of firms and products being considered is broad enough that a coordinated 5 percent increase in price would be unconstrained and, therefore, successful.[8]

Dr. Israel emphasized that documents and economics should not be separate but rather should reinforce each other. An expert should be comfortable diving deep into case documents to bring color and detail into economic arguments. However, after diving deep, one must come back up for air, making sure that the audience does not lose sight of why the points being discussed are important to the case.

On this point, Prof. Bresnahan noted that the importance of clear, jargon-free communication is not unique to merger cases. Rather, this is a problem routinely faced by expert witnesses presenting statistical analysis in many litigation settings. An expert should ensure that the economic analysis he or she is presenting is not a black box. It should live in the industry being analyzed. Each industry has a different way of talking about competition-related issues—for example, what products or firms compete with each other? This industry-specific language is not tutored by antitrust analysis. It is an expert's responsibility to intermediate between the facts on the ground, as presented in case documents and

[8] This thought experiment corresponds to the small but significant and non-transitory increase in price (SSNIP) test described in the Merger Guidelines. Merger Guidelines, §4.1.1.

discussed by industry insiders, and antitrust concepts. In doing so, the expert must direct attention to the substance of a case—whether the merger harms competition and raises prices.

Direct Examination

Mr. Simmons steered the panel to the question of the role of direct examination in merger trials, and how economic experts can make the most of the opportunities it presents. Quoting Herb Stern's well-known book on the subject, he noted that direct examination provides the opportunity to "lead without leading."[9] He asked the panelists to comment specifically on the role of demonstratives and other "bells and whistles."

Mr. Wall began by noting that there is a big difference between court and jury trials. In court trials, when the attorney's objective is to convince the judge of his or her position, there is a better chance of successfully explaining more complicated concepts. Attorneys may also get more leeway in court trials to lead an expert witness to, in essence, make a presentation. They are unlikely to get away with that in a jury trial. Mr. Wall told the story of a merger trial where asking the CEO for his name led to a twenty-minute discussion of case issues, prompting the judge to ask Mr. Wall to "toss a question in there, at least."[10] It is important to take full advantage of the leeway given.

Mr. Wall also shared part of his expert witness strategy for merger trials. He likes to use two experts. One expert acts as a closer, presenting economic analysis that brings everything the court has heard together. However, he cautioned against waiting until the end of the trial to present economic analysis of the issues in the case. Thus, an additional expert is needed to tell the economic story and start educating the court. That was Mr. Wall's strategy in Oracle.[11]

Finally, Mr. Wall remarked that an important role of counsel during direct examination of an economic expert is to ensure that the expert does not forget to make any of the points he or she had planned. One way to do this is simply to prompt the expert by saying, "you make a good point, let's follow up…." Having a presentation is also useful, and may provide a valuable reference for the judge as well.

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[9] Stern, Herbert J. (1992). *Trying Cases to Win: Direct Examination*, Wiley Law Publications.
[10] United States et al. v. Oracle Corporation, No. C 04-0807 VRW (*Oracle*). Mr. Wall was attorney for Oracle.
[11] The defense's economic experts were Jerry Hausman and Tom Campbell. *See* US v. Oracle Corp., 331 F. Supp. 2d 1098 (N.D. Cal. 2004), at 1153.

Mr. Mohr was next to share his thoughts on the topic. He noted that the expert's report is generally a good point of reference for direct examination. According to Mr. Mohr, the objective of direct examination is to provide the judge with a framework for organizing the record. Usually, this means going through the Merger Guidelines. Direct examination presents an opportunity to address anticipated criticisms of the expert's analysis and opinions. The expert can address these proactively at this stage rather than in cross-examination or rebuttal. If the expert is effective in doing this, his or her testimony can defang the other side's plans for cross.

Prof. Bresnahan commented on this question, stressing the importance of preparation. There must be complete agreement between the expert and counsel on each point in the presentation—what it says and why it is there. The discussions that lead to this agreement can be very useful in clarifying the contribution of each point to the overarching economic story.

Making Forward-Looking Analysis Convincing

Mr. Simmons turned the panel's attention to the forward-looking nature of merger trials. Other types of antitrust cases are about the past. Mergers are about predicting the likely competitive effects of a transaction—"reading the tea leaves." What strategies do the panelists have for convincing the court that their predictions about the future are credible?

Mr. Mohr was first to address this question. For him, the first thing to do is familiarize the judge with the Merger Guidelines. The Guidelines describe ways in which competitive outcomes can be predicted. One must explain why the techniques in the Guidelines are reliable. There are several ways to do this:

- Conduct robustness tests and sensitivities: use multiple datasets and multiple methodologies.
- Explain assumptions: emphasize conservative approaches (i.e., favorable to the other side). In Sysco, the judge made a point of noting the importance of this.[12]

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[12] Memorandum Opinion, Federal Trade Commission et al. v. Sysco Corporation et al., at 91. ("Dr. Israel ran his merger simulation using that lower-bound market share estimate and still reached the conclusion that, absent significant efficiencies, the merger would likely cause significant harm…. The court, therefore, concludes that Dr. Israel's merger simulation model strengthens the FTC's prima facie case that the merger will substantially lessen competition in the market for national customers.")

- Present multiple analyses: particularly to establish the likelihood of unilateral effects.

- Point out how the analysis is consistent with documents in the record: the analysis is more credible if every type of evidence points to the same conclusion.

Mr. Wall noted that the government tends to build its cases by pointing to the past as an indicator of the future. The complaints in Staples and Sysco include a series of examples where the merging parties compete for the same business.[13] The government's burden, then, is to convince the court that not much has changed.

Another approach involves looking for natural experiments—for example, bankruptcies or prior mergers. These are situations where the number of firms in a market decreased as they would if the merger being analyzed is approved. If these situations are similar enough to the one at hand, one can argue that the prediction currently being made should have occurred following the previous event as well.

The panel then turned their attention to a hypothetical exhibit put together by Dr. Israel showing market share and Herfindahl-Hirschman Index[14] calculations under different assumptions about market definition and using different sources of data (e.g., revenues, square footage of distribution centers). Dr. Israel pointed out that the FTC's market structure analysis in Sysco was convincing partly because it was robust—all versions of the analysis showed a substantial increase in market concentration. A risk of this strategy, however, is that it opens the expert up to cross-examination about what the "right" methodology is.

Prof. Bresnahan acknowledged that it is hard to respond to this type of analysis. Walking through reasons why each of the N scenarios presented are wrong is likely to be tedious and takes too much time. This makes it more

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[13] A list of "examples of direct price competition between Sysco and US Foods for National Customers" is provided in: Complaint, *Federal Trade Commission et al. v. Sysco Corporation et al.*, No. 1:15-cv-00256, filed February 20, 2015, ¶67. *See also*, Federal Trade Commission Administrative Complaint In the Matter of Staples Inc. and Office Depot Inc., filed December 7, 2015.

[14] "The HHI is calculated by summing the squares of the individual firms' market shares.… For example, a market consisting of four firms with market shares of thirty percent, thirty percent, twenty percent, and twenty percent has an HHI of 2600 ($30^2 + 30^2 + 20^2 + 20^2 = 2600$). The HHI ranges from 10,000 (in the case of a pure monopoly) to a number approaching zero (in the case of an atomistic market)." Merger Guidelines, §5.3.

important for parties to articulate an alternative affirmative view of how competition works in the industry, rendering the other side's analysis ineffective and the multiple sensitivities irrelevant.

The Role of Price Discrimination in Sysco

At this juncture, Mr. Simmons presented the panelists with the following question about the Sysco case: The Sysco opinion argues that there was no pre-merger price discrimination because Sysco and US Foods constrained each other. After the merger, without this constraint, the merged entity would price discriminate among its customers in individual negotiations. However, this is not price discrimination—if the products do not have similar characteristics, and if clients are not consistently on the list of national customers, how does one price discriminate?[15]

Mr. Mohr accepted the premise that products in Sysco were differentiated, but also noted that "national broadline" customers were buying homogenous services of distribution, consistency, and access to a broad line of services. While Section 3 of the Merger Guidelines is limited to "customers purchasing the same or similar products," it also notes that "[f]or price discrimination to be feasible, two conditions typically must be met: differential pricing and limited arbitrage."[16] The first condition refers to the ability to charge different customers different prices; this is likely met in a market characterized by individual negotiations. The second condition refers to the inability of buyers to acquire the product at a lower price by purchasing it indirectly through other customers.

Dr. Israel disagreed with Mr. Simmons' premise that there was no price discrimination prior to the Sysco–US Foods merger. National buyers were getting consistently lower prices. Sales forces were divided into those serving national and local clients. Documents indicated that there were two businesses: national and local. The key question was: To what extent were lower margins for national customers due to competition between the merging parties? Market shares to national buyers were largely from Sysco and US Foods. Documents and testimony pointed to close competition between the merging parties in this segment. Upward pricing pressure (UPP) models suggested that the lower margins would be lost.

[15] For more on this question, *see* Hassi, Ted, and Ian Simmons (2015), "FTC v. Sysco: 'Price Discrimination' Markets and The Rule of Law," *The Threshold*, 16, no. 1.
[16] Merger Guidelines, §3.

Prof. Bresnahan countered that, under the government's market definition, there were only two sellers in national markets. In local markets, both sides agreed that buyers could choose between Sysco, US Foods, and many others. Thus, basic economics contradicts the theory that competition between Sysco and US Foods led to lower margins for national customers—the national market was more concentrated than local markets under the government's theory.

In turn, Dr. Israel argued that local buyers usually had one distribution center close to them, giving that provider a competitive advantage over others that translated to Ricardian rents.[17] In contrast, distances to distribution centers averaged out for national buyers.

Cross-Examination

Mr. Simmons moved the discussion to the panel's final topic, cross-examination, by quoting Herb Stern again, who noted that cross-examination amounts to "allowing the attorney to testify."[18]

According to Mr. Wall, counsel has to win on cross-examination. The appearance that things did not go well for one side is a huge win for the other side. The judge can get lost in the details, but he or she will understand mistakes. If an expert gives an answer that is clearly wrong, or presents a demonstrative that the other side is able to show is flawed, that will make an impression. It is not the most important thing, but the theater of trial is a significant contributor to trial outcomes.

Mr. Mohr agreed with Mr. Wall's portrayal of cross-examination, saying that "you have to go after everything in cross." The expert's deposition can serve as a roadmap. Ideally, an expert's deposition will have uncovered inconsistencies that can be exposed during cross-examination. These can be inconsistencies between experts, between the expert and documents, between the expert and company executives (this can show that the expert's analysis does not reflect business realities), or between the conclusions reached by different methodologies. Going after the reliability of the expert's data or the assumptions implicit in the expert's analyses can be effective as well. The court is looking for a roadmap for resolving conflicts between experts.

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[17] Ricardian rents are those earned by virtue of having a competitive advantage over one's competitors due to the control of a scarce resource (in this case, a favorable location). For a treatment focused on antitrust issues, *see* Coleman, Mary, and David Teece (1998), "The Meaning of Monopoly: Antitrust Analysis in High-Technology Industries," *Antitrust Bulletin*, 43, 801-857, at 818.

[18] Stern, Herbert J. (1995). *Trying Cases to Win: Cross-Examination*, Aspen Publishers.

According to Prof. Bresnahan, an expert has to have the will to prepare to win; cross-examination tests that will. The expert should show that he or she knows the facts of the case and has taken them all into account in reaching conclusions. Dr. Israel agreed, noting that preparation is important. Lawyers should put the expert through a tougher test at the preparatory stage than the expert will go through at trial. In order to ease the expert's cognitive burden, counsel should also steer an expert toward a single good answer to any given question rather than presenting many possibilities.

The panel ended with audience questions about the difficulty of communicating complex economic analyses to judges and juries, and on the credibility of surveys.

Spring Meeting Program – Summary of Panel Discussion: Price War: Reconciling Conflicting National Pricing Restraints[1]

Speakers:

Yong Huang, Director of Competition Law Center and Professor of Law, University of International Business and Economics, Beijing;

Robert E. Kwinter, Blakes Cassels & Graydon LLP, Toronto;

Jorge Padilla, Senior Managing Director and Head of Compass Lexecon Europe;

Joy K. Fuyuno, Director of Competition Law for Asia, Microsoft Corporation, Singapore

Moderator: *Deena Jo Schneider*, Schnaider Harrison Segal & Lewis LLP, Philadelphia, PA

Sponsor: American Bar Association, Section of Antitrust Law, Economics, Distribution & Financing and Pricing Conduct Committees

Date: April 7, 2016

On April 7, 2016, a panel discussion entitled "Price War: Reconciling Conflicting National Pricing Restraints" was presented by the Distribution & Franchising, Economics, and Pricing Conduct Committees of the ABA Section of Antitrust Law at the 64th ABA Section of Antitrust Law Spring Meeting in Washington, DC.

The panel was moderated by Deena Jo Schneider, Schnaider Harrison Segal & Lewis LLP, Philadelphia, PA. Speakers included Yong Huang, Director of Competition Law Center and Professor of Law, University of International Business and Economics, Beijing; Robert E. Kwinter, Blakes Cassels & Graydon LLP, Toronto; Jorge Padilla, Senior Managing Director and Head of Compass Lexecon Europe; and Joy K. Fuyuno, Director of Competition Law for Asia, Microsoft Corporation, Singapore. Xin (Roger) Zhang translated for Professor Huang.

The discussion centered on regional differences in the regulation of pricing and included topics such as Resale Price Maintenance ("RPM"), Manufacturer's

[1] Prepared by Gadi Mazor and Divya Mathur, Analysis Group, Inc.

Suggested Retail Price ("MSRP"), Manufacturer's or Minimum Advertised Price ("MAP"), Most Favored Nation ("MFN") clauses, Price Restraints on Distribution, Bundled and Loyalty Discounts, Price Discrimination and Excessive Pricing Levels. Topics were outlined by Ms. Schneider, and panel members provided commentary in the context of their respective region of expertise.

Topic I: Resale Price Maintenance ("RPM")

Professor Huang opened with a discussion of RPM in China. Historically, the government has been influential in regulating price setting. In 2008, measures were implemented to render the market more independent. The structure of this system adds to the enforcement challenge. There are two official legal authorities involved—the National Development and Reform Commission ("NDRC") reviews pricing issues and the State Administration of Industry and Commerce ("SAIC") reviews non-pricing issues. There is a difficulty in determining which entity should preside over which matter as some matters involve both pricing and non-pricing issues. Another difficulty is deciding whether to apply common law or the rule of reason. Typically, common law is applied. However, in some cases such as the recent Johnson & Johnson matter, the rule of reason principle was applied.

Ms. Fuyuno addressed RPM in Asia outside of China. The region has diverse laws and enforcement regimes. Countries such as Korea, Australia and Japan have relatively well-established antitrust laws, while in Myanmar, the Philippines and Hong Kong, the system is more recent. There are large difference in both the analytical framework and the standard and substance applied to vertical conduct. For example, Malaysia includes it under the anti-competitive agreement provision, whereas some countries use standalone provisions and others include it under unfair trade practices. In many countries (e.g., Japan, Korea and Singapore), vertical conduct is addressed via the abuse of dominance provisions. Regarding the standard, in many jurisdictions, there is *per se* liability for minimum price fixing. For example, strict liability is practiced in Australia and was practiced in Japan and Korea until recently. Also, with respect to minimum vs. maximum prices, it is unclear whether maximum prices will be universally permitted in the region; maximum prices are prohibited in Korea while in Australia and India they are permitted.

Mr. Kwinter noted that in Canada, the tribunal has to be convinced that an adverse effect on competition exists and it has a relevant test in place to examine this question. In a worst case scenario, the conduct would be prohibited, but no

fines or penalties would be applied. Moreover, RPM may not be used as a foundation for a civil cause of action in Canada.

Mr. Kwinter added that in Canada, RPM is not based on a notion of vertical agreement; the conduct comprises any effort to exert upward pressure on prices by agreement, threat, promise or other similar means. The rule not only encompasses agreements but also unilateral conduct (the violation is always with the supplier). Canada does not have a "Colgate Doctrine" in place as does the U.S. that would permit suppliers to announce a price maintenance program and terminate buyers that do not comply. Canadian law covers both price maintenance and advertised price maintenance. It also makes refusal to supply based on the low pricing policy of the purchaser[2] a reviewable trade practice where the conduct would have an adverse effect on competition. Mr. Kwinter concluded that the main takeaway is that in the absence of market power, it is generally safe to engage in RPM or MAP programs.

Mr. Padilla then addressed RPM in Europe, noting that it constitutes a hardcore restriction, meaning a restriction by object.[3] Anti-competitive effects are presumed and do not need to be demonstrated. Restrictions by object can be defended using efficiency arguments and precedents. If it is not possible to quote an existing rule as a pre-set rule, there is an option to defend the practice under Article 101(3).[4]

In addition, Mr. Padilla commented that RPM is commonly used by companies with market power to protect their investment and prevent free riding at the distribution level. Efficiency justifications have been demonstrated empirically in the context of companies without market power. There is a need for balance when there are both efficiency arguments and potential anti-competitive effects. RPM can be anti-competitive when the company engaging in

[2] "The Bureau considers that a refusal to supply or discrimination in the supply of a product will have occurred 'because of the low pricing policy' of a person or class of persons where the low pricing policy is the proximate cause of the supplier's refusal or discrimination." Government of Canada, Competition Bureau, Price Maintenance, Competition Act Section 76 at 3.1.3, available at http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03687.html#s3_1_1.

[3] "Restrictions of competition 'by object' are those that by their very nature have the potential to restrict competition. These are restrictions which in the light of the objectives pursued by the Union competition rules have such a high potential for negative effects on competition that it is unnecessary for the purposes of applying Article 101(1) of the Treaty to demonstrate any actual or likely anticompetitive effects on the market." European Commission, Competition, Guidance on Restrictions of Competition 'by object' for the Purpose of Defining Which Agreements May Benefit from the De Minimis Notice, available at http://ec.europa.eu/competition/antitrust/legislation/de_minimis_notice_annex.pdf, p. 3.

[4] Competition, Article 101(3), European Commission, available at http://ec.europa.eu/competition/antitrust/legislation/art101_3_en.html.

it has significant market power and when the RPM agreement is not unique. In that context, the RPM agreement can facilitate collusion. In those circumstances, anti-competitive effects can be problematic and interventions may be warranted.

Mr. Padilla commented that Europe is treating RPM agreements as a quasi-per se rule because efficiency justifications protecting the distributers against free riding can be achieved by other means such as exclusive distribution, which is less restrictive on competition and can achieve similar efficiencies. Mr. Padilla concluded that RPM as a quasi-per se rule helps induce businesses to move towards and adopt other forms of vertical restraints that may be less offensive to competition. Ms. Schneider noted that while in the U.S. evaluation of RPM is now based on the rule of reason, many companies are reluctant to establish RPM programs as the law has not yet developed on what would be considered a valid justification for RPM.

Topic II: Manufacturer Suggested Retail Price ("MSRP") and Manufacturer or Minimum Advertised Price ("MAP")

Mr. Kwinter addressed the topic with respect to Canada. MSRP has two components. First, the ability to suggest a price to a customer is an exception to the RPM rule. However, the customer must be informed that a price reduction will not result in supplier-induced repercussions. Second, under the Misleading Advertisement provision, it may be a reviewable conduct to make a price claim that is not properly supported. Consider, for example, a seller that claims an MSRP of $100 and a selling price of $50 with no support for his MSRP. There are tests in place to satisfy the regulator regarding actual MSRP.

Ms. Fuyuno added that in Asia, there are not many precedents in this area and what little there is suggests that countries take a stricter approach toward advertised price or suggested retail price. For example, in Japan, in the Johnson & Johnson matter, instructing one's partners not to advertise price was considered a violation of the Anti-Monopoly Law ("AML"). Ms. Fuyuno concluded that in light of the lack of precedent, it is probably not safe to assume MAP or other types of advertised price restrictions would be allowed in Asia.

Topic III: Price Restraints on Distribution

Ms. Fuyuno discussed the topic in Asia, noting a quandary regarding the strict approach to RPM restraints and also to non-price restraints which raises the question of how a company should manage its distribution. There is a range of non-price restraints explicitly addressed in the law, especially in Japan and

Korea. Enforcers in emerging regimes appear to be looking for bright line rules. In Japan and Korea, pricing restraints can be challenged as an abuse of dominance, but also as an unfair trade practice, somewhat similar to what is covered by Section 5 of the Federal Trade Commission Act[5] – except that unfairness is often presumed to be inherent in the listed activities. There is a specific unfair trade practice regarding trading on restrictive terms. It is unclear to what extent competitive effect or justifications would be taken in to account because all that is required is likeliness to impede fair trade or unfairness. Case examples include Johnson & Johnson's request that retailers not disclose prices in advertisements and also a Japan Fair Trade Commission ("JFTC") consultation that considered a company's prohibition on sales without face-to-face product explanation to restrict sales over the internet. Both forms of conduct were considered to be trading on restrictive terms, and therefore AML violations.

Ms. Fuyuno noted that in Japan and Korea, abuse of superior bargaining position[6] is another broad unfair trade practice, which is not dependent on market power. There is a similar provision in the recent draft revisions to the Anti-Unfair Competition Law in China. Superior bargaining position is almost presumed – in most cases the supplier (even non-dominant) would be considered to be in a superior bargaining position to its trading counterparty. For example, a recent case in Japan involved Toys"R"Us Japan's alleged requirement that suppliers accept the return of unsold products[7]. This provision is challenging for companies to comply with as it applies a strict liability like approach to a broad range of non-price restraints, which may not be fully defined.

Mr. Kwinter added that in Canada, there is no unfair bargaining provision. There are three principal provisions: (1) Exclusive Dealing, (2) Market Restriction and (3) Tied Selling. One and two are non-criminal, civilly reviewable matters. The only effective remedy is the instruction to cease the practice and only when a dominant position exists because there has to be a substantial lessening of competition arising from the practice. There are not many historic examples under Exclusive Dealing or Market Restriction.

[5] "Section 5: Unfair or Deceptive Acts or Practices," U.S. Federal Trade Commission, available at https://www.fdic.gov/regulations/compliance/manual/7/VII-1.1.pdf.
[6] "Guidelines Concerning Abuse of Superior Bargaining Position Under the Antimonopoly Act (Tentative Translation)," Japan Fair Trade Commission, 2010, available at http://www.jftc.go.jp/en/legislation_gls/imonopoly_guidelines.files/101130GL.pdf .
[7] "Cease and Desist Order and Surcharge Payment Order against Toys'R'Us-Japan," Japan Fair Trade Commission, 2011, available at http://www.jftc.go.jp/en/pressreleases/yearly-2011/dec/individual-000456.html (on appeal).

Mr. Padilla noted that in Europe, upstream manufacturers can create selected distribution networks and can restrict how distributors in the network sell, but not where they sell and to whom they sell. It is presumed that the markets for online and offline buyers are different. An online restriction is considered a restriction of to whom to sell and where to sell and therefore considered to be anti-competitive. Clauses restricting distribution on third-party platforms such as eBay are a non-issue because they are defined as a restriction on how to sell and not where to sell and to whom to sell. However, some courts in Europe may not agree and classify those clauses as restrictions on to whom to sell and where to sell.

Professor Huang commented that in China the relevant issues are differentiating between price and non-price restrictions; determining whether a price set by a company with a dominant position is legal; and considering the legality of non-pricing restrictions under both the Anti-Monopoly Law ("AML") and other antitrust and competition laws.

Topic IV: Bundled and Loyalty Discounts

Mr. Padilla noted that in Europe bundled rebates can be viewed as price tying and conditional rebates may take the form of volume discounts, exclusivity rebates, loyalty rebates, and others. Some types of rebates raise competition concerns under either Article 101,[8] which discusses agreements, or Article 102,[9] which discusses abuse of dominance. Article 102 concerns materialize when significant market power exists and are likely to result in more restrictive constraints on a seller than concerns presented under Article 101.

Bundled rebates can be problematic, depending on whether the discount level is excessive as determined by applying a price cost test. The implied price (the price of the bundle less the price of the bundling product on a standalone basis) is compared to the long term incremental cost of producing the product. If the test shows that the implied price is below the incremental cost, there may be an investigation as to whether the discounts are used in a manner that may result in foreclosure effects.

[8] Antitrust Exempted Agreements (Article 101(3) TFEU), European Commission, Competition, 2004, available at http://ec.europa.eu/competition/antitrust/legislation/art101_3_en.html.
[9] Antitrust Procedures in Abuse of Dominance (Article 102 TFEU Cases), European Commission, Competition, available at http://ec.europa.eu/competition/antitrust/procedures_102_en.html.

Regarding conditional rebates, Mr. Padilla added that the law is more formalistic as compared to economic. The law distinguishes three types of conditional rebates. First, volume discounts must be justified in terms of economies of scale. Second, based on the most recent precedent (Intel[10]), exclusivity rebates must satisfy two conditions to be considered abusive: (1) the company that is using the exclusivity rebates is an unavoidable trading partner (subject to definition), and (2) the rebates cannot be justified as a matter of efficiency. If market power exists, exclusivity rebates can also pose a problem from an Article 102 perspective. Third, whether loyalty rebates are regarded anticompetitive depends on whether they generate loyalty, which occurs when the dominant company enjoys a non-contestable share of demand and uses conditional rebates to leverage the non-contestable share of demand onto the contestable share of demand.

Mr. Padilla referenced a recently decided case demonstrating that a loyalty program with less than 10% market share can have foreclosure impact. European courts argued that dominant companies should not influence market structure and any effect on market entry should be prohibited. The position on conditional rebates is considered fairly aggressive. Ms. Schneider noted that similar debates occur in the U.S., with different jurisdictions reaching different conclusions and applying varying approaches.

Ms. Fuyuno noted that Australia has a unique third line forcing[11] provision, which covers conditioning a sale on the purchase from a third party. This is considered to be an offense separate from the unilateral conduct provision, subject to *per se* liability. Even a requirement to purchase from a group of third party entities could fall under this provision. Ms. Fuyuno added that there is little precedent regarding loyalty incentives in Asia, other than the Intel cases.

Topic V: Price Discrimination

Ms. Fuyuno noted that in most of Asia, discrimination can be viewed as a specific type of exclusionary conduct that could constitute an abuse of dominance. In Japan and Korea, it can also be addressed as an unfair trade practice. This

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[10] Judgment in Case T-286/09 Intel Corp. v Commission, Luxembourg, General Court of the European Union, 2014, available at http://curia.europa.eu/jcms/upload/docs/application/pdf/2014-06/cp140082en.pdf.

[11] "Third line forcing occurs when a business will only supply goods or services, or give a particular price or discount on the condition that the purchaser buys goods or services from a particular third party. If the buyer refuses to comply with this condition, the business will refuse to supply them with goods or services." Anti-Competitive Behaviour, Exclusive Dealing, Third Line Forcing, Australian Competition & Consumer Commission, *available at https://www.accc.gov.au/business/anti-competitive-behaviour/exclusive-dealing*.

topic is a concern in Asia and if addressed as an unfair trade practice, it is not clear to what extent market power or competitive effects will be taken into account.

Mr. Kwinter noted that in Canada, it is possible to engage in almost any type of discount without competitive violation concerns. The provision for significant administrative monetary penalties under abuse of power specifically includes predatory pricing, but discounting practices can also result in an abuse of power where a dominant position exists. Canada does not have a Most Favored Nation ("MFN") provision. However, RPM guidelines reference MFN clauses as potential RPM issues (e.g., in the eBooks case[12]).

Mr. Padilla addressed the topic in Europe noting that except for a number of cases in Spain, there are not many precedents. Usually, such allegations are part of a larger set of issues raised. Pricing to market is not a concern for companies irrespective of market power. Regarding vertical restraints, Mr. Padilla posed the question about why it is possible to build an exclusive distribution network, but problematic to have a selected distribution network with restrictions on where to sell. It is possible to implement pricing to market with exclusive distribution, but not with selective distribution. Pricing to market is a problem in the EU if the company takes measures to prevent parallel imports, but a non-issue with non-EU countries.

Mr. Padilla continued to comment on MFN, especially in the context of hotel reservations. He focused on the topic of price parity provisions that say that when a hotel's rooms are being offered via platform X, if the hotel endeavors to rent directly or via other platforms, it cannot undercut platform X. This may prove problematic for two reasons. First, similar to RPM, this limits inter-brand competition. Second, it may prevent the entry of a third-party platform that wishes to enter via cost-cutting for consumers. These cases are a challenge given that there is a need to balance anti-competitive effects and potential efficiencies. As a matter of economics, in principle, he suggested using the rule of reason. Certain instances that appear to be price parity provisions are actually content parity provisions (e.g., platform X offers to rent a hotel's rooms, but requests access to similar rooms the hotel is offering directly or offering to other platforms). Distinguishing the two is a nuanced issue in his opinion.

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[12] "Justice Department Reaches Settlement with Three of the Largest Book Publishers and Continues to Litigate Against Apple Inc. and Two Other Publishers to Restore Price Competition and Reduce E-book Prices," U.S. Department of Justice, Office of Public Affairs, 2012, available at <https://www.justice.gov/opa/pr/justice-department-reaches-settlement-three-largest-book-publishers-and-continues-litigate.

Mr. Padilla added that another issue relates to the definition of an agent and whether a third-party platform is an agent of the hotel. In the U.S., the classification of an agent is based on who bears the transaction risk. In the EU, the definition includes the transaction risk as well as the general risk associated with the activity. The selling platform may not bear transaction risk, but because of its significant investment in developing the platform, it is considered an agent. For example, the MFN case concerning Expedia and booking.com[13] was viewed as a matter that potentially restricted competition in order to bypass the agency discussion. Even though this was not an RPM matter, it had similar effects.

Professor Huang commented that in China, in principle, the rule of reason is applied. However, no precedent exists. For example, internet sales are considered a new industry with many players as a result of government support and favorable consumer reaction. Some internet companies are very similar to each other, which leads to intense competition as well as ample choice for consumers. At times, these companies will provide significant discounts to win market share. In his opinion, MFN may increase horizontal competition in China.

Ms. Fuyuno added that a recent competition policy review in Australia had considered the possibility of a "no international price discrimination" provision based on a similar Canadian proposal. However, the report ultimately recommended against any such legislation. Another development of note is the creation of the Association of Southeast Asian Nations ("ASEAN") Economic Community, which theoretically could decide to include price discrimination measures similar to those in place in Europe.

Topic VI: Excessive Pricing

Ms. Schneider noted that the U.S. does not have excessive pricing rules, but a company can unilaterally set prices at any level it wants, as long as it is not engaging in an unfair practice. However, other countries do have laws in this area.

Professor Huang noted that in China, determining the fair price is a challenge. In a previous case, the court could not decide on a fair price and could not reach a ruling. The company in question suggested providing a discount, but this was not a result of a legal proceeding. Another issue is that in some pricing

[13] "CMA Closes Hotel Online Booking Investigation," United Kingdom, Competition and Markets Authority, 2015, available at https://www.gov.uk/government/news/cma-closes-hotel-online-booking-investigation.

cases, the decision is not made by a court as in the U.S., but by the enforcing entity.

Mr. Padilla commented that Europe first developed the concept of excessive pricing but it is not clear what excessive means. When considering whether a price is excessive, international price comparisons are conducted. A price will be considered excessive if there is pricing to market in export markets, which makes limited sense in his opinion. The general consensus is to use this tool only in exceptional circumstances such as in markets with barriers to entry, newly liberated markets, when a market is unlikely to self-correct, when an ex-monopoly has clout that enables it to sell at high prices, or in cases in which limiting a price would not have detrimental effects on investment and innovation.

Mr. Padilla went on to note that the consensus that is developed in Europe may not apply in other jurisdictions that are implementing excessive price laws, as demonstrated, e.g., by the Mittal[14] and Sasol[15] cases in South Africa. These cases involved open markets that did not satisfy the conditions for intervention mentioned above. In these intermediate goods industries, the competition authority appears to have been conducting some form of industrial policy and shifting rents from one layer of the vertical chain to another in order to protect or favor domestic companies operating at downstream levels or competing in international markets. Also in this category of cases are some of the recent interventions regarding excessive pricing in IP and standard essential markets (e.g., the Qualcomm case[16]). Similar interventions have occurred in Taiwan and Korea. Mr. Padilla is concerned about the application of the excessive pricing instrument in these markets where investment and innovation are particularly important and reducing rents is an essential incentive to investing decisions. In his opinion, excessive pricing is problematic when it is used as part of an industrial policy attempt to lower the IP cost of domestic companies competing in international markets and thus as a trading instrument that undermines trade liberalization.

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[14] "Policy Round Tables, Excessive Prices," The Organisation for Economic Co-operation and Development ("OECD"), Competition Committee, 2011, available at http://www.oecd.org/competition/abuse/49604207.pdf, p. 31.

[15] "Excessive Pricing Verdict in Sasol Polymers Case," South African Competition Tribunal, 2014, available at http://www.competition.org.za/review/2014/8/13/excessive-pricing-verdict-in-sasol-polymers-case.

[16] "China's National Development and Reform Commission Notifies Qualcomm of Investigation," Qualcomm, 2013, available at https://www.qualcomm.com/news/releases/2013/11/25/chinas-national-development-and-reform-commission-notifies-qualcomm.

As the program came to a close, Ms. Schneider noted that on almost every practice discussed, at least one jurisdiction appears to take a very strict view as to its legality and asked the panel members how companies might set their policies in light of this fact and all the differences in approaches covered. It was generally agreed that in establishing international pricing, companies can use either a lowest common denominator approach (universal pricing) or a country customized approach. Neither alternative is completely satisfactory, and most companies are likely to end up with a hybrid. Many companies may adopt the lowest common denominator approach for convenience but adjust their policies in key markets with significant volume. The hope was expressed that over time there will be greater convergence and consistency among jurisdictions at least in the same general region to assist companies in developing pricing policies – and that strict line rules will be applied with caution and concern over their impact on competition.

Summary of Session on Unilateral Effects in the Fundamentals of Antitrust Economics Series[1]

Guest Speaker: *Jeffrey Prisbrey*, Vice President at Charles River Associates

Moderator: *Sophie Meadows*, Edgeworth Economics

Sponsor: American Bar Association, Section of Antitrust Law, Economics Committee

Date: April 28, 2016

On April 28, 2016, Dr. Jeffrey Prisbrey graciously gave the third presentation to the American Bar Association Section of Antitrust Law in a series titled Fundamentals of Antitrust Economics, providing instruction on the fundamentals of unilateral effects theories in horizontal mergers. Dr. Prisbrey is currently a Vice President of Charles River Associates ("CRA"). Prior to joining CRA, Dr. Prisbrey was a Vice President with Competition Policy Associates. He also served as a Senior Economist at both the Department of Justice, Antitrust Division and the Federal Communications Commission. Dr. Prisbrey earned a PhD in Economics from the California Institute of Technology and taught as a Visiting Assistant Professor at the Department of Economics at the University of Virginia.

Dr. Prisbrey began the presentation by defining the two main types of mergers. Horizontal mergers combine firms that provide products that are economic substitutes for each other, meaning that consumers view those products as substitutes. Vertical mergers, on the other hand, combine firms that provide products that are economic complements, meaning that the products are not substitutable but are consumed together in some way. Dr. Prisbrey explained that the term "vertical" applies to any merger that raises issues of complementarity, foreclosure or exclusion. Dr. Prisbrey also explained that some lawyers acknowledge a third category, conglomerate mergers, which combine firms that offer unrelated products. However, he stated that economists would say that all products are related in at least some way, so from an economic perspective, conglomerate mergers are likely theoretical.

Dr. Prisbrey explained that a horizontal merger can produce two main anticompetitive effects. First, a horizontal merger can create "unilateral effects" if

[1] This summary has been prepared by Daniel K. Oakes, Associate at Axinn, Veltrop & Harkrider LLP.

the post-merger firm would have the incentive to behave anticompetitively on its own, without any help or cooperation from another competing firm. In other words, the structure of the market and the firm's incentives are such that the company would change its actions, even if the merger causes no changes in the way other firms in the market behave. Second, a horizontal merger can create "coordinated effects" if the post-merger firm would change its behavior with respect to other market participants, through facilitating collusion or cooperation among competitors.

Dr. Prisbrey stated that a horizontal merger can create both negative and positive market effects. For example, a merger may create a negative effect if it leads to the elimination of a competitive constraint on a market participant and thereby gives that firm an incentive to increase prices. On the other hand, a merger may create a positive effect if it creates marginal cost savings for the merged firm, providing an incentive to lower prices. The goal of merger analysis is to try to weigh the negative and positive merger effects against each other to determine which one dominates. Unilateral effects analysis allows one to estimate the net effect of the merger in a consistent manner.

Dr. Prisbrey stated that unilateral effects are addressed in Section 6 of the Horizontal Merger Guidelines where several common market situations are discussed, including differentiated product markets, homogeneous product markets, auction markets and others.

Dr. Prisbrey first focused on the most common situation—unilateral effects analysis in differentiated product markets. Dr. Prisbrey taught that a differentiated product market consists of a set of products that contain some close substitutes that compete more strongly against each other and other more distant substitutes that compete less strongly with each other. The "ready to eat cereal" market is a prime example - a walk down the cereal aisle at the grocery store shows the many dimensions on which different products compete (e.g., crunchiness, sugar content, fiber, brand, generic) and the large number of products to meet different consumer preferences. There are many other examples of differentiated markets, including automobiles, baby food, restaurants and grocery stores.

Dr. Prisbrey taught that economists measure how close different products are in a product space by calculating "diversion ratios." The diversion ratio asks the question: if a firm raises its price on a product and loses customers, what will those lost customers buy as an alternative? Put differently, the diversion ratio

from Product 1 to Product 2 is the percentage of lost customers that switch to Product 2 because of a price increase on Product 1. By way of example, Dr. Prisbrey stated that if Product 1 loses ten customers due to a price increase and five of those switch to Product 2, then the diversion ratio from Product 1 to Product 2 is 50%. If six of those lost customers switched to Product 2, the diversion ratio would be 60%. Thus, the closer the substitutes, the higher the diversion ratio will be, and the diversion ratio serves as a measure of substitutability that can be measured and compared across different products.

Dr. Prisbrey then stated that firms find optimal prices by balancing the competing effects of a price increase. On one hand, there is a positive income effect as the customers who continue buying the product pay more and the firm will make additional money on each unit sold. On the other hand, depending on the elasticity of demand, there is also a negative switching effect as a price increase will cause some customers to purchase another product and the firm will lose all the revenue from that sale. Firms will increase price as long as the additional income gained is greater than the loss from switching customers. The firm's optimal price will be the point at which the gain from a price increase equals the loss—enough customers will switch away from the product to make further price increases unprofitable. Dr. Prisbrey emphasized that these effects work in a similar, though converse, way when a firm decreases price.

Dr. Prisbrey taught that "upward pricing pressure" ("UPP") can result when two firms offering substitutable, differentiated products merge. In the post-merger world, because the products are now jointly-owned, some diverted customers that would have been lost if prices were increased pre-merger are now recaptured. For example, if some customers of Firm A would have switched to Firm B in response to a price increase, after a merger between the firms, Firm A would lose less revenue than it would have pre-merger because it owns Firm B and the combined firm does not face the same magnitude of lost sales it would have before the merger. In such a circumstance, the combined firm would optimize profits by raising prices until it became unprofitable to do so further. This tendency for the merged firm to raise prices after recapturing lost customers is called UPP.

Economists seek to estimate UPP by measuring the value of the diverted sales. Dr. Prisbrey noted that, pre-merger, a lost sale would be worth nothing to a firm (i.e., would produce no revenue). However, post-merger, a lost sale would be worth something because some sales would be diverted to the acquired

substitute product. Dr. Prisbrey said that the value of the diverted sales is expressed in the following equation:

$$D_{12} * (p_2 - c_2)$$

where D_{12} is the diversion ratio from Product 1 to Product 2; p_2 is the price of Product 2; and c_2 is the marginal cost of Product 2. For example, if the diversion ratio between Product 1 and Product 2 is 25%, and the price and marginal cost of Product 2 are $6 and $4, respectively, then for every lost sale from Product 1, the merged firm would expect to earn $0.50. This is a measure of UPP for this merger.

Dr. Prisbrey stated that economists use another measure, called the Gross Upward Pricing Pressure Index ("GUPPI"), to reach a unitless scale of pricing pressure that can be compared across industries and may be used as a screening mechanism for anticompetitive harm. The GUPPI is expressed in the following simplified equation:

$$\frac{D_{12} * (p_2 - c_2)}{p_1}$$

which is the value of diverted sales (expressed above) divided by p_1, the price of Product 1.[2] This results because, if the value of diverted sales is small relative to the price of Product 1's current sales, then there will be little UPP. However, if the value of diverted sales is large relative to the price of Product 1's current sales, then significant UPP will result. The GUPPI calculation produces in an index scale that facilitates sensible comparison. For example, maintaining the prior assumptions and further assuming that the price of Product 1 is $6, the GUPPI would be 8.3%.

Dr. Prisbrey then mentioned that merger efficiencies can lead to lower marginal costs for the post-merger firm, which cost reductions counteract UPP and create the incentive for the merged entity to lower prices. The GUPPI is therefore used as an indication of the "compensating marginal cost reduction" ("CMCR"), which is the level of cost savings that is needed to exactly offset the UPP of the transaction.

Dr. Prisbrey warned that the GUPPI is still a matter of controversy in the profession and there is no consensus on what is an acceptable (or unacceptable)

[2] With some simple manipulation, one arrives at the more typically used GUPPI formula: $D_{12} * M_2 * (P_2/P_1)$, where M_2 is Product 2's margin.

index level. Some economists have argued that various thresholds have significance. For example, some have suggested that a GUPPI below 5% indicates that anticompetitive harm is unlikely, while a GUPPI above 10% is a sign of likely harm, with the range in between being indeterminate.

There are other areas of controversy as well. Where margins are very small (often a sign of strong competition), the GUPPI will also be small and suggest a low probability of harm. Yet this might be misleading where the diversion ratio between the merging firms is very high. In such a circumstance, the diversion ratio by itself may be a better tool for identifying harm. Moreover, the GUPPI assumes that other factors remain constant that may cause downward pricing pressure, such as reductions in marginal costs due to merger efficiencies (although the GUPPI does indicate how large efficiencies would have to be to overcome the upward pricing pressure), entry or expansion and product repositioning. Nevertheless, despite its shortcomings, Dr. Prisbrey believes the GUPPI is a useful and commonly-used index.

Dr. Prisbrey stated that it is often necessary to perform more complicated analyses that can account for the factors that are assumed away in the GUPPI analysis. In such cases, Dr. Prisbrey said that economists will perform merger simulations, which can better account for and balance competitive responses to price changes as mentioned above.

Dr. Prisbrey then turned from differentiated markets to a second type of common market situation in which unilateral effects arise: bidding markets. In contrast to differentiated product markets where the firms set price and consumers choose among available options, bidding markets consist of buyers who have power to negotiate prices which are set on a case-by-case basis. Dr. Prisbrey offered the example of a buyer of large, expensive turbines for use in power generation, which are infrequently purchased and are used for a long period of time. Such a buyer will often utilize an auction in which it invites bids from manufacturers with the technical capabilities to produce the needed product and then awards a contract to the lowest bid that meets the required specifications. In such a case, the products offered are not very differentiated (they all must meet the buyer's specifications), but bidders with different capabilities demonstrate their value by competing to provide the lowest price. In such an auction, the most capable manufacturer would win the contract at a price just below the price offered by the second lowest bidder.

Dr. Prisbrey stated that in auction markets of this type, unilateral effects are analyzed by determining how much information is available to the bidders. If there is complete information—i.e. all bidders know each other's capabilities, the order of the bids, offered prices—then a merger between the lowest bidder and a competitor other than the second-lowest bidder will not affect the outcome of the auction. This is because the second-lowest bidder is the constraint against which the winning price is set. On the other hand, if bidders do not have perfect information, they will act in a probabilistic manner. The more uncertainty that the bidders face, the more the analysis becomes similar to that used in a differentiated product market. In such a situation, economists estimate diversion ratios based on the probability of winning. Conversely, if the bidding order is certain, the most important thing is whether the merger is between the first and second best alternative.

To conclude, Dr. Prisbrey highlighted the commonly considered topics that he did not cover during his presentation, including defining markets, counting firms and calculating HHIs. Dr. Prisbrey explained that when he first started doing merger analyses, these were all types of things that economists would look at very closely in analyzing unilateral effects. Today, however, the focus has shifted away from these artificial and arbitrary boundaries and toward estimating how closely products compete and how the firm's strategy for setting optimal price will be affected by the merger.

When the session was opened for questions, a member of the audience asked whether Dr. Prisbrey could expand upon the types of data that an economist would want to gather in order to perform a diversion analysis and merger simulations. Dr. Prisbrey responded that one must think about the important characteristics of the merging products that would lead to arguments about whether the products are close substitutes. Win/loss and churn data are often very helpful in observing direct substitution and those data can be analyzed in light of pricing or entry data to identify changes in diversion. Dr. Prisbrey cautioned, however, that the weight one can place on the results should account for the quality of the data used for the analysis.

To perform a merger stimulation, Dr. Prisbrey said that one would need data about non-merging market participants, such as prices and costs. While the government agencies can likely obtain this information without much trouble, it can be difficult for the parties (and especially third parties advocating against a merger) to get this information. Economists would then seek to model the

demand curve of the market and estimate equilibrium prices before and after the merger.

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Please contact the committee members if you wish to share suggestions for future brown-bag seminars, articles or publications.

To submit articles for a future newsletter or to comment on articles in this issue, please contact:

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