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# Economists Ink

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### Bid Markets: Factors to Consider When Only Some Firms Are Allowed to Bid

Philip B. Nelson discusses the implications of mergers in bid markets in which customers limit the number of bidders. For differentiated products, a merger may reduce the number of close substitute bidders leaving only bidders less effective at constraining price. For homogeneous products, differences in cost structures, an increased potential for bid rigging, and a reduced ability to replace bidders on the bid list may raise competitive issues.

### The Denver JOA and the Standard for "Failure"

Joseph W. McAnneny, Kent W Mikkelsen and James N. Rosse note that in the review of the Denver JOA, the Justice Department argued for a tighter standard to identify a failing newspaper. The proposed standard, unprofitability on an incremental basis, is similar to the Merger Guidelines standard. Using this standard in JOAs, however, may effectively prevent a JOA from forming.

### An Economist's Perspective on B2Bs

Margaret E. Guerin-Calvert considers antitrust issues that may arise from B2Bs. An FTC study highlights several areas of concern, but notes that well-crafted operating rules may solve most problems. To determine which B2Bs might raise concerns, she considers five categories based on factors like the level of industry involved or the type of B2B operator. Many similar issues arise across categories, but important differences emerge as well.


# Bid Markets: Factors to Consider When Only Some Firms Are Allowed To Bid

By Philip B. Nelson

In certain markets, each firm has the ability to supply a sufficiently large share of the total market such that the market price could not be increased above the competitive level without each firm's cooperation. Calculating shares in these "bid markets" has often involved assigning equal shares to all competitors because they all have the ability to frustrate anticompetitive price increases and because historical sales may misrepresent a firm's future competitive significance. While this approach appears straightforward, complications can arise. For example, significant transaction costs, such as the costs of preparing and/or reviewing a bid, may cause a customer to limit the number of firms that are invited to bid. Specifically, assuming that "M" firms bid and that there are "M+N" firms in the industry, should one be concerned about mergers or other structural changes that reduce the number of firms in the industry, but leave more than "M" competitive firms?

In a differentiated product market, the antitrust agencies may be concerned about potential anticompetitive unilateral effects. If the merging firms offer very close substitutes, for example, and there are relatively few other firms that sell close substitutes, then customers that had both firms on their bid lists may find that the merger has reduced the number of close alternatives. Moreover, within the group of firms that are allowed to bid, the two merging firms may be viewed as the two leading and closest competitors. If the third firm is a distant alternative, the antitrust authorities may be concerned that there will be a post-merger price increase because the first firm's bid will no longer be constrained by the second firm, and the third firm will not be as effective a competitor.

In an industry with homogeneous products, the agencies recognize that the competitive effect of the merger will depend on firms' cost structures, customers' contracting procedures, and suppliers' reactions to these procedures. While an anticompetitive effect appears less likely when a merger leaves more than "M" competitors (the number of firms that customers typically allow to bid on contracts), the agencies do not rule out the possibility of anticompetitive effects.

The agencies have identified at least three concerns. First, they have recognized that when firms have different cost structures, the competitive significance of firms may differ, even if they could supply much or all of an industries' needs. The combination of the two lowest-cost firms may allow a unilateral post-merger price increase because the third-ranked firm may not be able to sell profitably at as low a price. Moreover, if the firms' costs rise with increased output or if there are fundamental capacity constraints, in-

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# The Denver JOA and the Appropriate Standard for "Failure"

By James N. Rosse, Joseph W. McAnneny and Kent W Mikkelsen

On May 12, 2000, the *Denver Rocky Mountain News*, owned by E.W. Scripps Co., and *The Denver Post*, owned by MediaNews Group, Inc., applied to enter a joint operating arrangement (JOA). Under a JOA, commercial competition between the two newspapers would be suspended. Though they would remain editorially independent, a single management entity would assume many of their business functions, set circulation and advertising prices for both newspapers, and distribute profits from those operations equally to the two owners.

Such an agreement would normally be illegal under the antitrust laws, but the 1970 Newspaper Preservation Act (NPA) permits newspapers to obtain limited antitrust exemption if at least one of the newspapers is a "failing newspaper." The NPA sought to preserve multiple independent newspapers where there would otherwise likely be only a single newspaper. During the decades preceding the NPA, head-to-head competition between two or more general circulation newspapers in the same city had become increasingly rare. Other media had grown, attracting some of the advertising previously available to newspapers and taking over some of newspapers' former news and entertainment functions. Rival newspapers found it harder to differentiate themselves, and increasingly tried to capture the same audience.

In head-to-head competition, the newspaper that falls behind in key performance areas is very likely to fall further behind. Newspapers are unusual because they sell two distinct but interrelated products. Advertisers buy space in a newspaper to obtain effective exposure to potential customers. Advertiser buying decisions depend not only on the price charged per unit of published space, but also on the size of circulation, which is determined by readers' demand for circulation. Readers' decisions to buy the newspaper, in turn, depend in part on the amount of advertising in the newspaper, which readers value for its own sake. Newspapers typically increase the amount of news and feature content in parallel with increases in advertising space. Thus, the level of circulation sales depends in part on the level of advertising, just as the level of advertising sales depends in part on the circulation level.

In many newspaper markets, this interrelationship has led to a "downward spiral" for the newspaper that fell behind. In a typical scenario, some external event or management misstep causes one newspaper's circulation to fall behind its rival. This loss of circulation increases the newspaper's average costs and reduces its attractiveness to advertisers. A reduction in advertising leads to further circulation declines, causing further declines in advertising, and so forth. As circulation and advertising fall and average costs mount, the newspaper eventually becomes uneconomic.

Neither of the Denver newspapers, however, had succumbed to the "downward spiral." Circulation and advertising levels were approximately equal. Yet to maintain this rough parity, the *News* had sustained substantial negative operating income throughout the 1990s. Attempts to eliminate these losses were likely to place the *News* in a downward spiral, and no reasonable prospect existed of restoring the *News* to profitability.

In previous JOA decisions, a newspaper was considered failing if it was in probable danger of financial failure in the reasonably near future. The *News* clearly met this standard. The Department of Justice (DOJ) argued for a stricter standard, however, requiring that the *News* be unprofitable on an incremental basis. This standard, similar to part of the Merger Guidelines' failing division test, would ascertain whether the incremental costs of operating the *News* exceeded the revenue generated by the *News*. Editorial staff and newsprint costs would count, but depreciation and corporate expenses would not. An analysis of the *News*' finances showed that, even on an incremental basis, the *News* had been a consistent drain on its parent, Scripps. As a result, DOJ recommended that the JOA application be approved without a hearing.

In Denver, the choice of a standard for "failure" did not change the outcome because the *News* met both tests. In the future, however, the NPA's goals would be better served if DOJ's incremental standard were rejected in favor of the less stringent conventional standard of "probable danger" of future failure. First, an incremental standard can be so high that it effectively prevents a JOA from forming. A newspaper without corporate funding may be forced to close down soon after it becomes incrementally unprofitable. If this condition is known to its potential JOA partner, however, the partner has little or no incentive to enter a JOA, preferring to publish a single newspaper without competition from its closest rival. Under an incremental standard, a newspaper may not be eligible for a JOA until the JOA is unattainable. Second, the incremental standard does not meet its objective of denying a JOA to all newspapers that would not otherwise immediately close. The *News* has continued operating for years even though it is incrementally unprofitable. Newspapers may rationally continue to operate unprofitably if they believe the rival newspaper may exit first or agree to a JOA. Thus, the incremental standard would not insure that only newspapers about to close would be eligible for a JOA. For these reasons, the conventional "probable danger" standard should be used in future JOA analyses.

*Director and Special Consultant James N. Rosse, Principal Joseph W. McAnneny, and Vice President Kent W Mikkelsen prepared several papers which were cited in the Antitrust Division's recommendation.*

# An Economist's Perspective on B2Bs

By Margaret E. Guerin-Calvert

Although while the number and variety of business-to-business (B2B) electronic marketplaces is vast, most are unlikely to raise substantive antitrust concerns. A recent comprehensive review by the Federal Trade Commission (FTC) of B2Bs highlights that potential antitrust concerns stem largely from market structure, information exchange, and operating practices. It observes that B2Bs raise structural issues that are familiar in many joint ventures and networks and that efficiencies can be substantial. Importantly, the report notes that "it appears likely that many potential concerns could be eliminated through well-crafted B2B operating rules."

In order to identify the types of B2Bs that are most likely to raise concerns, it is useful to divide B2Bs into five categories based on the following criteria: (1) the level of the industry involved - manufac-turing, input supply, distribution and sale; (2) the type of B2B operator - proprietary or joint venture; (3) the nature of connections among the participants in the B2B vertical or horizontal or both; (4) the presence and continued viability of alternatives - Internet and traditional arrangements; and (5) the role of the Internet - replacing alternative forms of communication or allowing the creation of new or expanded services.

*A Proprietary Purchaser-Supplier B2B* includes arrangements between a single purchaser (e.g., a manufacturer) and one or more suppliers. It includes pure vertical arrangements in which a purchaser organizes and operates the B2B to enhance obtaining supply on a timely basis and to seek out low cost and qualified suppliers. The B2B's Internet site may entail spot auctions, requests for bids on longer term contracts, or other interactions designed by the purchaser to increase information about supply availability. In many respects, such sites may replace traditional communications or create a new marketplace for transactions. Due to the proprietary and vertical nature of the B2B and the absence of connections among the suppliers, these B2Bs raise few competitive issues.

> It appears likely that many potential concerns could be eliminated through well-crafted B2B operating rules.

*A Shared Purchaser or Supplier B2B* includes multiple participants at the purchaser or supplier level. This B2B continues to be primarily vertical with no connections among suppliers (or among purchasers) and has all of the features of the Proprietary Purchaser-Supplier B2B. The competitive issues that arise stem from the presence of more than one company at the purchaser level or at the supplier level and are similar to issues that arise in the context of other buyer groups such as shippers associations. This form of B2B raises potential concerns about the share of purchases accounted for by the joint venture partners, the ability to purchase outside of the venture, and whether competitively sensitive information is exchanged at a horizontal level. Another issue is whether the B2B itself has the ability to charge non-competitive fees to participants. Such B2Bs may differ from joint purchasing groups by providing a marketplace for individual purchasers to make purchasing decisions on their own behalf. There may be "network" features similar to those involving networks of providers in the healthcare context which may raise concerns about information exchange and operating rules (e.g., exclusivity). Whether these fea-

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## Selected EI Cases

### *WorldCom's Proposed Merger With Sprint*

Senior Vice President John H. Preston testified in Brussels at the European Commission's (EC) hearing on the proposed merger of WorldCom and Sprint. His analyses of Internet backbone and global telecommunications services issues concluded that the proposed merger would likely harm competition in the former but not in the latter. The proposed merger was subsequently abandoned because of opposition by the EC and DOJ. Mr. Preston, assisted by Vice President Robert D. Stoner, worked with Hogan & Hartson and Jones, Day, Reavis & Pogue on behalf of British Telecommunications and AT&T.

### *DRAM Dumping Order*

Vice Presidents Robert D. Stoner and Matthew G. Mercurio worked with Willkie, Farr & Gallagher on behalf of Hyundai Electronics for the sunset of a 1993 International Trade Commission dumping order concerning Dynamic Random Access Memory computer chips. They demonstrated that the price and volume effects in the U.S. of the original order were insignificant. They also showed that revocation of the order was unlikely to injure domestic producers. The matter was settled by the domestic industry agreeing to support revocation of the order.

## Bid Markets . . . (Continued from Page 1)

dividual competitors or groups of competitors may no longer have the unilateral ability to discipline the market. While this need not mean that it is improper to assign equal shares to all competitors, the resulting concentration levels must be interpreted with care.

Second, the agencies have been concerned about the possibility that a subset of firms might conspire to rig the bid price when just the conspirators submit bids. According to this theory, when a non-conspirator bids, the conspirators bid competitively. As a result, a merger that eliminates a non-conspirator may increase the chance of only conspirators being chosen to bid.

Third, the agencies have expressed the concern that the presence of additional firms that are not allowed to bid might affect the behavior of the firms on the bid list. If firms that bid high prices on one bid are replaced on the next bid by firms that did not bid, firms might submit lower bids in order to preserve their position on the bid list. In addition, there may be some form of non-price competition to get on the bid list that could be affected adversely by the merger.

Responses to one or more of the agencies' theories include the presentation of evidence showing that (1) cost-effective entry or expansion is easy, (2) markets are improperly defined, (3) firms that currently are not close competitors can reposition themselves, (4) the merging firms are not particularly close competitors, (5) the differentiating characteristics are not really important to customers, (6) customers have effective strategies for preventing anticompetitive effects, and (7) other benefits associated with the merger will offset any of the alleged anticompetitive effects.

The fact that a bid market is characterized by transaction costs that limit the number of firms that are asked to bid to a subset of market participants does not mean that the antitrust authorities will not be concerned about reducing the number of independent participants. To the contrary, the agencies have identified circumstances under which they will be concerned. However, these concerns may be resolved through a careful factual analysis of bidding institutions, competitive characteristics of the different firms in the industry, and other relevant structural factors.

*Principal Philip B. Nelson has worked on numerous mergers that have involved bid markets, including mergers in defense, oil, natural gas, chemical, school supply, and financial markets.*

## An Economist's Perspective on B2Bs . . . (Continued from Page 3)

tures generate competition problems depends on the specific nature of the information exchanged and the transactions that occur through the network as well as on the availability of alternative networks, both Internet and traditional.

*A Shared Production B2B* creates networks or products comparable to the formation of shared ATM systems. Shared Production B2Bs may involve creation of complex databases and common standards that could not be accomplished by individual participants. Since a Shared Production B2B is likely to have network features (i.e., enhanced value to the network participants as more suppliers and purchasers are involved), issues may also arise as to the availability on a sustained basis of competing networks. Hence, issues of "access" or exclusivity arrangements may be relevant and operating rules will receive close scrutiny. These B2Bs may involve complicated market definition questions.

*A Shared Distribution/Marketing B2B* involves a group of horizontal competitors that form a venture for the marketing or distribution of their products. Likely competitive issues include exchange of information on pricing among competitors, presence of competing systems, and the availability and use of alternatives to the venture for both the B2B members and others.

*An Exchange or Auction B2B* includes a wide range of possible exchange formats to create a marketplace in which buyers and sellers can trade goods and services. Fewer of these B2Bs are likely to raise competitive concerns, but concerns may include privacy, access to listings, or linkages among sites. Auction B2Bs may compete with each other to provide the best format/quality to attract listings and inter-exchange competition will be an element of the analysis. Market definition issues include assessment of whether Internet and non-Internet auction or exchange arrangements are alternatives for the Internet sites.

As the FTC report indicates, there is much that is new and much that is familiar to practitioners in antitrust review of B2Bs. Most familiar are the elements of market definition and market share measures, although B2B "markets" will add new dimensions to this analysis. The area that is newer in many industries, although more familiar in network contexts, is the analysis of governing structures and operating rules of the networks. This will likely prove to be an important complement to structural considerations in antitrust review.

*Principal Margaret E. Guerin-Calvert has advised clients in several industries on B2B formation and operating rules. She testified at the June 2000 hearings on B2Bs at the FTC.*


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