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In This Issue

The Value of the FTC/DOJ's Commentary on the Horizontal Merger Guidelines to the Antitrust Practitioner

The FTC and Department of Justice recently published this Commentary to demonstrate how they enforce their Merger Guidelines. David D. Smith finds that while the Commentary offers no surprises, it does show that the agencies have made significant progress in their enforcement policy. Moreover, the Commentary provides valuable information concerning how the agencies approach the fundamental issues in merger analysis.

Reasonable and Non-Discriminatory (RAND) Royalty Rates and Standard-Setting Organizations

The Broadcom and Rambus decisions raise the issue of reasonable and non-discriminatory (RAND) royalties in a standard-setting context. Robert D. Stoner describes the criteria for determining if royalties are reasonable and non-discriminatory. He then discusses how standard setting organizations (SSOs) can arrive at such royalties without contravening the antitrust laws. An ex ante auction may be the best way of finding the RAND rate.

An Apparent Lack of Price Competition is not Proof of Conspiracy

Several recent price fixing cases involve products that have many different attributes, each of which is separately priced. Plaintiffs argue that an apparent lack of competition involving the price of a single attribute is evidence of a conspiracy. John M. Gale describes economic models that show that firms may appear not to compete on the prices of certain product attributes even if there is no collusion and the market is very competitive. These models seem to describe a recent case involving credit card issuers.

The Value of the FTC/DOJ's *Commentary on the Horizontal Merger Guidelines* to the Antitrust Practitioner

By David D. Smith

The Federal Trade Commission and U.S. Department of Justice have jointly published this *Commentary* to demonstrate how they have enforced the 1992 Merger Guidelines and to increase the transparency of their merger enforcement decisions. The *Commentary* should help companies and their advisors to better predict those decisions and reduce uncertainty with regard to merger planning. Private practitioners no doubt would like more detail on specific decisions than this broad *Commentary* provides. Nonetheless, this *Commentary* is a step in the right direction and can help practitioners understand the agencies' perspective on merger policy.

The current Merger Guidelines provide a general methodology for analyzing the competitive impact of mergers. The analysis of any particular merger, however, is fact-intensive. This *Commentary* goes beyond the generalized rules of the Merger Guidelines to explain how the agencies examined and interpreted the evidence acquired in the investigations of over 70 specific mergers. These 70 investigations are only a small and non-random sample of all those conducted by the agencies during the last ten to eleven years. They apparently were chosen to make certain points about key issues often faced in merger analysis.

Almost all of the examples can be counted as "wins" for the agencies in that they entailed court victories or consent decrees providing some or all of the relief requested. Members of the defense bar might wonder if the agencies have biased their results by selecting examples that put themselves in the best light. The *Commentary* does not, however, purport to be a statistical summary of merger enforcement results. Describing the analysis behind these agency "wins" provides useful information for predicting future enforcement decisions.

The *Commentary* has two salient features. One is the lack of surprises. These examples show, at least for the examples given, how the enforcement of merger policy has generally been consistent with the Guidelines. The other is the progress made in merger enforcement policy. The modern age of merger enforcement began roughly with the 1982 Merger Guidelines, which marked the start of a general consensus about the fundamental goals of merger policy. Since that time, our knowledge of how to achieve those goals has increased significantly.

The investigations described in the *Commentary* cover the fundamental issues in merger analysis: product and geographic market definition, concentration, competitive effects, entry, and efficiencies. Highlights for these topics are summarized below.

Product Market Definition - Where available, scanner data have been used to estimate demand elasticities, but the agencies usually rely on non-econometric evidence. In cases where arbitrage is infeasible, perhaps because of product customization or the importance of a service provided, narrow price discrimination markets were defined.

Geographic Market Definition - In mergers of hospitals and similar healthcare facilities, patient-origin data were used in the analysis. A key factor in geographic market definition for electricity markets was power line constraints at peak times.

Continued on page 4

Reasonable and Non-Discriminatory (RAND) Royalty Rates and Standard-Setting Organizations

By Robert D. Stoner

Two recent antitrust cases raise the issue of reasonable and non-discriminatory (RAND) royalties in a standard-setting context. In *Broadcom v. Qualcomm,* the complaint alleged that Qualcomm promised a standard setting organization (SSO) that it would license its technology at RAND rates and then reneged on the promise. The U.S. District Court dismissed the complaint. In the recent *Rambus* case, the Federal Trade Commission (FTC) found that through deceptive conduct before an SSO, Rambus engaged in an anticompetitive "holdup" of the computer memory industry. Rambus did not divulge to the SSO that it had patents that were required for a contemplated standard. Once the standard was promulgated, Rambus sued those practicing the standard for patent infringement and demanded high royalties. The FTC now will determine a remedy, which is likely to include a RAND royalty. Thus the principles of RAND licensing probably will play a significant role in the remedy phase of the Rambus matter.

The economic principles that underlie a properly calculated RAND licensing rate are generally accepted. A RAND licensing rate must assure the licensor/patent holder at least as much profit as it could have obtained through refusal to license, as well as compensate the licensor for any incremental costs associated with licensing. If the patented technology is clearly superior to other technologies that could have been used to form the standard, this minimum royalty is likely to be significant. At the same time, the RAND license must offer the licensee an opportunity to profit from the license, if it is able to manufacture the product utilizing the intellectual property (IP) at a lower cost than the licensor/patent holder. RAND rates will not exist in all circumstances, but if they do exist, there likely will be a range of rates that fulfill these criteria.

RAND rates likely will exist in the typical standard-setting situation. That is because IP suppliers who participate in the standard-setting effort and agree to a RAND license gain substantial benefits. These include the ability to design the standard to conform to proprietary specifications, the ability to steer the standard-setting effort away from competing designs, and the ability to gain an advantage over other suppliers in producing products that meet the standard. Because the adoption of the standard will likely promote use of the patented technology, the standard can be very profitable for the IP supplier. Still, finding an appropriate RAND rate may be difficult.

Standard setting often involves ex ante-consultation and agreement among firms that compete in both IP and downstream markets. For this reason, SSOs that adopt policies that will lead to RAND royalties risk running afoul of the antitrust laws. For example, standard-setting activity that aims collectively to reduce the price paid for intellectual property could be interpreted as anticompetitive or collusive, even though such joint decision making also would appear likely to promote economic welfare by advancing a new standard.

Allowing ex ante discussions on royalties is likely to be pro-competitive because it prevents a firm from gaining additional market power through the incorporation of its intellectual property in the standard. Thus, the ex ante discussions may lead to maximum royalties that will be lower than they would be in a world with an ex post holdup following the choice of a standard. Ex ante royalty discussions should be considered under a rule of reason analysis and not subject to automatic (per se) condemnation. Ex ante royalty discussions may lead to faster standards development and less ex post litigation. These pro-competitive benefits should be weighed against any possible competitive concerns with ex ante royalty discussions.

There are a number of ways that standard-setting bodies could attempt to implement a RAND licensing obligation and still avoid antitrust problems. First, the SSO could simply require patent holders whose patents are required for a proposed standard to commit to RAND licensure. It may not be possible, however, to put such a contractual commitment in language precise enough to protect all parties in an SSO. The imprecision of a commitment to RAND licensure was an underlying issue in the *Broadcom* case.

Second, the SSO could require each IP holder unilaterally to commit to specific licensing terms before the adoption of the standard. Then the SSO participants who are also prospective licensees will take the different patent owners' licensing terms into account when considering whether to adopt a standard for which a patent is essential. One problem with this approach is that the licensing terms in different proposals may not be easily comparable.

Third, patent holders and other SSO members could jointly engage in ex ante royalty determination through an auction mechanism. The SSO would conduct an auction as an explicit intermediary between patent holders and potential licensees. IP holders would bid to have their IP used in a standard by submitting detailed commitments to RAND licensing terms. Auction rules could be devised to ensure the offers were comparable. Auctions could protect competition in both the purchase and the sale of IP. The auction would be set up to discourage buyer collusion and would not involve collective royalty negotiations after bids had been submitted to the SSO. Moreover, the auction process would take advantage of competition before the standard is adopted, when different technologies are vying to be incorporated in the standard. Auctions would allow standard-setting bodies to prevent the exercise of ex post market power in licensing after a standard is chosen.

The *Rambus* and *Broadcom* cases highlight the difficulties that can arise when SSOs must deal with proprietary IP. Determining licensing terms for IP required by a standard may be one of the most difficult problems faced by an SSO. Nonetheless, typically a RAND rate exists that is efficient and allows all parties to benefit from the adoption of the standard. An ex ante auction may be the best way of finding this RAND rate.

Robert D. Stoner has worked on a number of IP-related cases while at EI. His experience includes consulting on the setting of RAND licensing rates in a standard setting context.

An Apparent Lack of Price Competition is not Proof of Conspiracy

By John M. Gale

Plaintiffs in price fixing cases often argue that the absence of price cutting and price advertising supports their allegation of a conspiracy. Several recent price fixing cases involve defendants that sell products that have many price components and features. Plaintiffs contend that although many price components are subject to substantial price cutting and advertising, others are not. They argue that the lack of apparent price competition involving a particular price component, in an otherwise competitive market, must be the result of conspiracy. Recently published economic literature, however, explains why firms sometimes will appear not to compete on the prices of certain attributes even if there is no collusion and the market is very competitive.

For example, plaintiffs in recent cases involving credit cards have argued that a lack of apparent competition over foreign exchange markups is evidence of conspiracy. Credit card issuers set interest rates, annual fees, card benefits, late payment fees, foreign exchange markups, and many other prices. The foreign exchange markup is the percentage markup that banks impose on transactions that were originally charged in a foreign currency. Plaintiffs allege that foreign exchange markups must have been collectively determined. These plaintiffs admit that banks compete over many other prices and features of credit cards, but they suggest that this competition in other attributes implies that the lack of apparent competition in foreign exchange markups must be conspiratorial.

Recently developed economic models, however, offer a non-collusive explanation for the credit card issuers' behavior. These models have introduced the term "shrouded attributes" for price components that exhibit less price cutting and aggressive advertising. The shrouded attribute models describe a market with two types of customers: sophisticated consumers that can avoid the high shrouded attribute price by choosing a cheaper alternative, and naïve consumers that do not investigate the price for the shrouded attribute.

Economists assume that firms will determine their pricing strategy based on the responses of consumers and competitors. Aggressive advertising and price cutting on the shrouded attribute will reach only sophisticated consumers; naïve customers do not base their purchasing decisions on that price. But sophisticated consumers can already avoid a high shrouded attribute price and will not shift their purchase in response to a lower price. In a competitive market, firms are unlikely to make supra-competitive profits. Therefore, if a firm has a higher price for one part of the product, it likely will have a lower price for some other part. The sophisticated buyer knows that the firm's shrouded attribute price allows it to charge lower prices on other components and, therefore, purposefully chooses to buy from a firm with a high shrouded attribute price. Thus, firms have no reason to cut shrouded attribute prices, and those prices remain high, even in a competitive market.

> "...firms sometimes will appear not to compete on the prices of certain attributes even if there is no collusion and the market is very competitive"

The assumptions and results of shrouded attribute models appear to describe the recent case of foreign exchange markups set by credit card issuers. As a credit card issuer, a bank sets many different prices for the features of the credit card to encourage people to carry and use the card. Some prices appear to have a strong influence on consumer choice (interest rates, card benefits, annual fees), while other prices have a much weaker influence (foreign exchange markups, late fees, penalty interest rates). Because of this difference in consumer responses, credit card issuers aggressively compete over interest rates and benefits but rarely promote lower late fees or foreign exchange markups. Both sophisticated and naïve consumers are attracted by

Continued on page 4

EI News and Notes

Alfa Laval/Tranter Merger Receives Antitrust Clearance

Alfa Laval and Tranter completed their merger after receiving clearance from the U.S. Department of Justice and the German Bundeskartelamt. Both companies manufacture gasketed plate heat exchangers, which are used in various manufacturing processes to dissipate heat. EI economists William C. Myslinski and David D. Smith worked with lawyers at Goodwin & Proctor LLP to defend the acquisition. They showed that after the merger, competition would be preserved by existing competitors, the ongoing expansion of fringe competitors, imports, and sales of other forms of heat transfer technology.

Testimony Before the Postal Rate Commission

Stephen E. Siwek submitted testimony to the Postal Rate Commission concerning the U.S. Postal Service's request for higher postage rates for mailing newspapers. He examined the Postal Service's cost studies and found numerous flaws in its data collection and analysis. He concluded that the Postal Service could not support its claim of a large increase in the cost of handling newspapers and other periodicals that pay "Within County" postal rates. Thus, the Commission would be well justified in rejecting the proposed rate increase. His testimony was presented by the National Newspaper Association.

ANSYS and Fluent Allowed to Merge

ANSYS was cleared by the FTC to acquire Fluent Inc. in a $300 million deal. Both companies sell Computational Fluid Dynamics (CFD) software, which is used to simulate the flow of liquids and gases. Many of the issues often confronted in software mergers were present in this deal. The acquisition will allow ANSYS to bundle Fluent's software with its own software suite to offer customers a broader array of products. EI economists William C. Myslinski, David D. Smith, and Robert A. Kneuper worked with lawyers at Goodwin & Proctor LLP to defend the acquisition.

Horizontal Merger Guidelines (Continued from Page 1)

Concentration - Market concentration numbers are not the final consideration in merger analysis, and they may not be important if unilateral anticompetitive effects are at issue. A post-merger HHI of over 3,000 was allowed in an industry where coordination would have been difficult. In other industries with similarly high concentration figures, the mergers were blocked because other factors made coordination more likely.

Competitive Effects - When considering whether a merger will lead to coordinated interaction, important considerations include concentration, evidence of past collusion, whether the acquired firm is a maverick, and whether the merger significantly reduces the capacity of fringe producers who might undermine collusion.

Unilateral effects analysis often uses the same information as market definition. In particular, simulation models that estimate the profitability of a unilateral price increase also may help define the market. The *Commentary* notes that challenges based on unilateral effects theories almost always involve firms with combined shares above 35%. The diversion ratio is extremely important in unilateral effects investigations. (The diversion ratio between two products is the proportion of the decrease in sales of a product that is switched to purchases of the second product, if the price of the first product increases.) The agencies will determine those ratios using both quantitative and qualitative information and will use econometrics if possible.

Entry - The *Commentary* discusses entry issues for consumer product markets and industrial product markets. Entry may not occur in markets for differentiated consumer products because a large sunk investment would be required to compete with the established brands. Moreover, the customers, who are retailers, may have little incentive to encourage entry to the extent they can pass price increases on to the final consumer. For industrial products, important issues include whether a new competitor would have trouble establishing a track record, whether it would need an extensive product line, and the time and sunk costs needed to build a factory. If contract manufacturing is feasible, that could eliminate the need for the factory. Other factors that might affect the significance of entry in specific industries are regulations and the need for specific intellectual property, particularly if the latter is patented.

Efficiencies - A key theme is that efficiencies must be merger-specific. The agencies, however, recognize that some alternative ways of achieving efficiencies may not be feasible. Efficiencies usually refer to cost reductions, but may also refer to other benefits, such as getting a new product to market faster. In a situation where anticompetitive harm was expected in one market and efficiencies were expected in another, the solution involved a divestiture only for the former market.

David D. Smith has extensive experience in analyzing the competitive effects of mergers both at EI and in his previous position at the Antitrust Division of the Department of Justice.

Price Competition (Continued from Page 3)

lower interest rates, while only sophisticated consumers choose based on foreign exchange markups. Perhaps because they rarely travel, naïve customers do not care about that markup. Sophisticated consumers can avoid a high foreign exchange markup on an otherwise preferred card by having a second credit card with a low markup that they use only for foreign transactions. Banks have little incentive to cut foreign exchange markups and advertise the lower price because that strategy will lose revenue on the naïve consumers they already have and will attract only sophisticated consumers who may limit their use to foreign transactions where they take advantage of the lower markups.

Before the development of shrouded attribute models, economists had developed models of repeated interaction that show that a lack of price competition does not necessarily indicate an explicit agreement. For example, tacit collusion models rely on game theoretic solutions to repeated interactions between firms. Firms come to realize that lowering price will generate increased sales only briefly, and then competing firms will match the price cut. The short-run sales gains do not offset the long-run losses from a lower price. Eventually a form of tacit collusion is reached, where each competitor maintains a high current price. Although there is no explicit agreement, firms do behave in a way that is not immediately profit-maximizing. Tacit collusion models best fit situations when prices are simple and easily observable. Shrouded attribute models examine the significance of an apparent lack of competition if prices are complex.

The lack of price cutting on a particular price component, such as credit card foreign exchange markups, is not the result of conspiracy. The lack of price cutting results from independent competitive actions of individual firms maximizing current profits. In contrast with other economic models, the current prices are profit maximizing, even in the short run without considering the responses of other companies. It is because of the vibrant competition in the overall market that some product components have higher prices.

Drawing on a background in game theory, simulation and auction models, and empirical studies of consumer demand, John M. Gale has extensive experience providing economic analysis of antitrust, regulatory, intellectual property and damages issues.

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