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Convergence of U.S. and E.U. Merger Enforcement

Robert D. Stoner discusses the recent convergence in merger enforcement practices in the United States and the European Union. More E.U. mergers have been challenged with coordinated and unilateral effects theories. Convergence has also appeared through changing U.S. views of captive output. In addition, both U.S. and E.U. investigations have relied increasingly on empirical analysis.

Jeopardizing a First-Mover Advantage

Bruce R. Snapp comments on the implications of lost first-mover advantages. Such advantages can yield long-lasting high shares and high prices for a pioneer brand. First-mover advantages are most apparent in industries with network effects, when consumers learn about the product's quality largely by trying it, and for those products in which customers' choices become habitual.

Antitrust Questions in Open Access to Broadband Cable Networks

Henry B. McFarland notes that cable companies' general policy of bundling high-speed Internet transmission service and ISP services raises some antitrust issues. He suggests, however, that the practice is unlikely to harm consumers. Moreover, bundling may lead to improved quality and incentives to conserve bandwith.

Convergence of U.S. and E.U. Merger Enforcement

By Robert D. Stoner

In recent years, a substantial convergence has occurred between merger enforcement practices in the United States and the European Union. Prior to 1989, E.U. merger enforcement was accomplished through two statutes not specifically designed to deal with mergers. With the passage in 1989 of the E.U. Merger Regulation, E.U. merger enforcement began a process of rationalization.

Historically, several differences have been noted between U.S. and E.U. merger enforcement practices. The E.U. merger statute is couched in terms of competitive effects emanating from the creation or strengthening of "a dominant position," and more emphasis has been placed on single-firm effects than on collusion. Thus while U.S. agencies consider both market share and concentration in their analysis, the E.U. authorities have not tended to consider high market concentration to be a decisive factor against allowing a merger.

In the last five years, however, a number of mergers in the European Union have been analyzed based on the theory that they created a duopoly or oligopoly. In May 1998, the merger of two U.K. tour operators, Airtours and First Choice, was halted because it was said to contribute to the creation of "collective dominance." This followed closely the finding of the European Court of Justice in an important appeals case that the European Commission had an obligation to analyze possible oligopolistic outcomes and needed to improve its economic analysis of potential coordinated effects. Most recently, the European Commission investigated the creation of a potential "duopoly" in the manufacture of certain flat-rolled products as part of its investigation of the Alcan/Alusuisse/Pechiney aluminum merger. Thus, the practical approaches of the United States and European Union towards merger issues are converging despite different technical language in their statutes.

The E.U. analysis of dominance has also tended historically to be a simplistic, market share-based exercise that involved little more than defining the market and calculating shares. More recently, however, E.U. analysis of dominance increasingly mirrors a more refined unilateral-effects inquiry. In the recent merger of Alcoa and Reynolds, the Commission appeared to be concerned that Alcoa and Reynolds were each others' closest alumina competitors in bidding situations and the removal of Reynolds would allow bidding prices to rise. Whether or not this analysis was done correctly, it is clearly an effort to apply the type of unilateral-effects inquiry that has become a staple of U.S. merger enforcement.

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Jeopardizing a First-Mover Advantage

By Bruce R. Snapp

Cases alleging the theft of proprietary information present interesting issues with respect to economic damages when the victim is a firm about to introduce a new product. The introduction of new products or brands ("pioneer brands") frequently involves proprietary information. If the theft of such information allows a new competitor to enter sooner than otherwise would be the case, the pioneer may have a smaller market share and realize lower prices at every point in time than would have been true, but for the theft. In many instances, such artificially accelerated entry might merely advance the onset of an unavoidable decline in the victim's initial position as sole supplier. Under certain conditions, however, pioneering brands may be subject to what economists called "first-mover advantages" that have enormous potential value.

First-mover advantages refer to the ability of the pioneer brand to differentiate itself from subsequent entrants, providing significant insulation from competition. As a result, the pioneer may continue to enjoy a dominant market share and price at a premium over subsequent entrants, thereby earning significant long-term rents. If the theft of proprietary information allows a second firm to enter at approximately the same time, competition may damage the true pioneer either by confering victory on the entrant or denying or reducing the pioneer's benefits. In such an instance, the magnitude of damages from the theft would be much higher than in the case where decline of the pioneer is inevitable.

Economic research indicates that first-mover advantages generally arise in industries where product differentiation is an important feature of market structure, and they are more important for consumer goods than for so-called producer (or industrial) goods. First-mover advantages may arise because of the nature of customers' demand characteristics or may be related to supply-side considerations. Other characteristics favoring the creation of first-mover advantages include the presence of so-called "network effects," buyer uncertainty about quality, and buyer habit formation.

Network effects exist when the value that individual consumers derive from using a product increases with the number of other consumers that also use the product. Telephone service is often cited as the paradigmatic case of a product that is subject to network effects. As more people subscribe to the same phone system, the value of that system increases to each person, because the number of people he or she can contact increases. If one brand has a chance to establish a large base of users in the presence of network effects, the subsequent entrants' market potential will be reduced compared to the pioneer's. Both existing and subsequent buyers are more likely to purchase and stay with the pioneer brand, even in the face of higher quality or lower prices by entrants.

Uncertainty about product quality can also create buyer inertia that imparts an advantage to a pioneer brand. For some products, consumers learn about the performance of a brand by consuming it rather than reading objective evaluations of its performance characteristics. While a pioneer brand must overcome the resulting buyer reluctance (typically by offering low initial prices), buyers that purchase the product and experience its quality will find the uncertainty dissipated. As a result, the pioneer will be able to raise its prices once it achieves significant buyer acceptance.

While subsequent entrants benefit from the pioneer's initial marketing efforts, they are likely to be at a significant disadvantage in terms of quality perceptions. Faced with a new brand, consumers must decide whether to continue purchasing a product they are happy with, or risk buying a product that may disappoint them. Moreover, when purchasing a new brand involves a significant cost, the risk will be higher if some or all of the cost cannot be recovered should the new product not prove to be as good as hoped. Whatever its source, this risk of disappointment in the face of satisfaction with the status quo creates an impediment that sellers of new brands must overcome.

Finally, buyer habit formation is a likely source of advantage to pioneer brands of experience goods. When buyers are satisfied with purchases, their choice is positively reinforced and can become habitual. Moreover, consumer preferences can be reinforced through advertising, and advertising has been cited as an important explanation for the success of many pioneer brands that are experience goods.

First-mover advantages can be observed for a large number of products, and the conditions under which they occur are reasonably well understood. Even under conditions favorable to a first-mover advantage, a pioneer is still not guaranteed success. Nonetheless, a pioneer with business skill and a quality product can expect to earn higher returns over time than it would if it had exactly the same product but was the second firm to enter the market. Artificially accelerating entry into a market through the theft of proprietary information can substantially and irreparably damage the true pioneer by denying it benefit of first mover advantages.

Principal Bruce R. Snapp frequently works on matters in high-tech industries where proprietary information is important. He has consulted and testified in matters in which the alleged theft of proprietary information threatened a pioneer brand's opportunity to reap the benefits of a first-mover advantage.

Antitrust Questions in Open Access to Broadband Cable Networks

By Henry B. McFarland

The issue of access to broadband cable networks has grown in importance as cable networks have become more popular modes of Internet transmission. Cable companies generally do not sell the two elements of cable modem service–high speed transmission and ISP services–separately, but rather bundle them for residential consumers. This practice has raised antitrust concerns of vertical restraints, bundling and exclusive dealing. ISPs that are not affiliated with cable companies want "open access," a requirement that cable companies unbundle their transmission services and sell them separately from ISP services.

> "Bundling high-speed Internet access and ISP services has raised antitrust concerns of vertical restraints and exclusive dealing."

Advocates of open access suggest several ways in which the bundling of transmission with ISP services may harm consumers. Bundling might allow cable companies to raise subscription prices to consumers if it enables the transmission provider to price discriminate. Through its relationship with an ISP, the cable company might be able to learn more about the value of its services to individual customers and increase prices to those who value high-speed Internet access the most. While an ISP may gain significant information about individual subscribers, however, it is not clear that that information would allow it to price discriminate. It is also unclear that such price discrimination would be harmful. The ISP might also be able to identify consumers who put lower values on high-speed Internet access and reduce prices to them.

Bundling also might allow cable companies to increase advertising prices. An ISP might be better able to help advertisers target messages to the consumers they most want to reach. Improved targeting would make the advertising more valuable, enabling the cable company to charge more for it. Such price increases, however, would result from a product improvement, not a reduction in competition.

Proponents of open access also argue that bundling will harm consumers by reducing their choice of ISPs. One of the suggested advantages of having a variety of ISPs is an increase in innovation. Even if bundling greatly reduced the number of ISPs, however many other potential sources of innovation, such as software developers and web site operators, would remain.

Moreover, if consumers value choosing from a variety of ISPs, then cable companies will have an incentive not to limit that choice. The more subscribers value the ability to choose from a variety of ISPs, the greater the extent to which eliminating that variety makes cable broadband service less attractive and reduces its subscribership. Thus, by restricting the variety of ISPs available, the transmission provider may lose subscribers and profits.

Bundling may also bring a number of benefits that would be eliminated with a policy of open access. Loss of these benefits would raise the effective cost of cable modem service or make it less attractive to consumers. As a result, an open access policy would make investments in cable broadband networks less profitable leading to lower investment in such networks.

Many of the likely benefits of bundling transmission with an ISP stem from the complementary nature of the services involved. The quality of the service that a cable modem customer receives depends not only on the cable company

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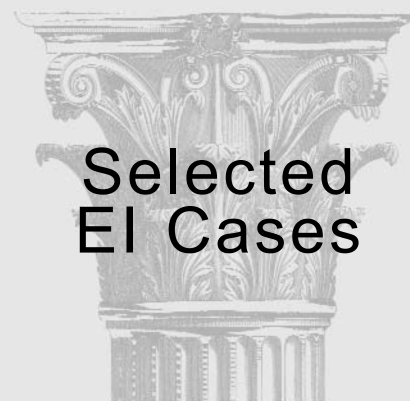

Selected EI Cases

Alcoa-Reynolds Merger

Working with Wachtell, Lipton, Rosen & Katz, Vice President Robert D. Stoner testified before the European Commission on behalf of Alcoa and Reynolds, which merged their aluminum businesses in a $4.8 billion transaction. Stoner, along with Principal Philip B. Nelson, analyzed issues primarily in alumina (an input to aluminum) and high-purity aluminum. The merger was recently cleared after a nine-month investigation by both the U.S. and European antitrust authorities with divestiture of some alumina refineries and a partial divestiture of a smelter.

Pride Refining v. U.S. Department of Defense

Vice President Paul E. Godek helped estimate damages and Principal Barry C. Harris testified for plaintiff Pride Refining regarding the impact of the Department of Defense's use of illegal price adjustment indexes in jet fuel contracts. The damages represent the difference between the estimated market value of the fuel and the amount specified in the contracts. In May 2000, the U.S. Court of Federal Claims entered judgment of $45.7 million for the plaintiff. Pride was represented by McKenna & Cuneo.

Convergence of Merger Enforcement . . . (Continued from Page 1)

Although the process of product market definition in the United States and European Union is generally similar, the area of captive output has sometimes been treated differently. The standard practice in the United States has been to include in the market output that is internally consumed, based on the theory that a price increase may bring an expansion of production or a shift away from internal use. In almost every recent Commission case where the issue has come up, internal sales have been excluded from the relevant market, which has been deemed to be "third party" sales. Despite the differences in past practice, definition of a "non-captive" market is becoming more likely in the U.S. enforcement context as well.

E.U. and U.S. merger policies have also converged in their reliance on empirical analysis as a central and often critical component of the competitive assessment. E.U. antitrust authorities now appear to recognize that when a rich body of data on prices and outputs in an industry is available, it can be used to test claims made by the parties. Increasingly, more sophisticated econometric techniques are being used to estimate own-price and cross-price elasticities of demand. Sophisticated empirical studies of bidding patterns have also been introduced in contexts in which firms bid for contracts, such as in the Boeing/McDonnell Douglas investigation. Analysis of bidding patterns has also been performed in other mergers in the European Union to determine whether two merging firms are each others' closest competitors.

Based at least partly on the convergence of the basic approaches to mergers in the United States and the European Union, some have suggested that a joint E.U./U.S. merger board should be established to regulate mergers that affect the interests of both jurisdictions. The rationale is to avoid the politicization of the antitrust process that may underlie the different decisions of the U.S. and the E.U. antitrust authorities with respect to mergers like the Boeing/McDonnell Douglas merger. This merger was not challenged in the United States, allegedly because McDonnell Douglas was too weak to be a competitively relevant factor. Despite this situation, the E.U. authorities challenged the merger, allegedly responding to a politically charged atmosphere in which Airbus would benefit from challenge. Some have argued that such a divided outcome could be avoided if there were joint reviews of mergers. The differences that have been observed in recent cases, however, may simply lead to disputes within the joint review process that would slow decision making and may not lead to superior joint decisions in politically tough cases. Nonetheless, joint review appears easier to implement today since the current substantive approaches to antitrust enforcement are very similar.

Vice President Robert D. Stoner has recently worked on matters involving E.U. antitrust review and has testified before the European Commission. He has also addressed this issue before the American Bar Association.

Open Access . . . (Continued from Page 3)

but also on the ISP. Cable broadband services will be more attractive to subscribers who can use ISPs that allow them to take full advantage of cable's broadband capabilities. By investing in fully compatible ISPs, cable companies can eliminate the risk that potential customers may be unwilling to pay to use cable networks because the available ISPs do not have adequate facilities.

Bundling may also help cable companies develop a reputation for quality service. Generally, a subscriber who receives poor service will be unable to determine if the problem lies with the cable transmission provider or the ISP. Thus, if consumers sign up for broadband service but do not receive the promised benefits because of their ISP, they may conclude that broadband transmission is not as good as promised. Cable companies can protect their reputation by controlling the quality of both the ISP and the transmission.

Sharing bandwidth, which occurs in cable broadband service, leads to another reason to allow bundling. Because users share bandwidth, the transmission speed to one subscriber can be reduced by heavy bandwidth use by other subscribers. Unaffiliated ISPs would have inadequate incentives to conserve bandwidth, because they only care about the service quality experienced by their own subscribers.

Even assuming that market power exists in cable broadband services, which itself is a questionable assumption, the case for requiring open access remains doubtful. Bundling broadband transmission with ISP services would not necessarily increase prices. A better case can be made that bundling will reduce variety in ISP services, but the significance of that effect is doubtful. Moreover, open access may sacrifice significant benefits that could come from bundling.

Senior Economist Henry B. McFarland has dealt with a variety of economic issues involving telecommunications. This article is excerpted from a longer paper presented at the American Bar Association meetings in July.

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