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A BRIEF ANALYSIS OF POLICY AND LITIGATION

Sports Verdict Affirmed Based on Market Definition

Jonathan L. Walker

Jonathan L. Walker, EI's President and Chief Executive Officer, testified in U.S. District Court on behalf of ATP regarding market definition, market power and competitive effects.

In the first sports antitrust appellate decision since the Supreme Court's ruling in *American Needle*, a Third Circuit panel affirmed the jury verdict in *Deutscher Tennis Bund (German Tennis Federation) et al. v. ATP Tour, Inc. et al.*

The ATP Tour operates a worldwide men's professional tennis tour including over sixty tournaments categorized into three tiers. The Tour sought to restructure itself to compete more effectively for fans, sponsors and programming revenues. The restructuring was intended to make the annual championship race more compelling, to better ensure top player participation at the highest tier events, to enhance the value of media rights and to expand in the Far East.

Pursuant to the restructuring, ATP reassigned the annual Hamburg Germany event from its top tier to its second tier. That event's owners, the German and Qatar Tennis Federations, sued based on Sections 1 and 2 of the Sherman Act. A jury found that the Federations failed to prove that the ATP contracted, combined or conspired with any separate entity under Section 1, and that they failed to prove a relevant antitrust market under Section 2.

The Federations appealed the Section 1 verdict, claiming that the District Court erred by instructing the jury that entities that "are commonly controlled or substantially integrated in their operations ... may be considered a 'single entity' or 'single enterprise' under the antitrust laws." The Federations also claimed that the District Court should have instructed the jury to analyze the Section 1 allegations under a "quick look" mode of analysis and thus relieve the Federations of the need to prove a relevant market or harm to competition.

Quick-look analysis applies to conduct such that "an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect ... ." Anticompetitive effects are presumed. If defendants articulate procompetitive justifications for their conduct, the presumption is dropped and the analysis proceeds using a rule of reason. The panel found that it would have been speculative to presume that there were any anticompetitive effects. Moreover, the ATP Tour's procompetitive justifications further mandated a full rule of reason inquiry. As both the Section 1 and Section 2 claims concerned the identical purported relevant market, the Federations' failure to prove a relevant market for purposes of its Section 2 claim necessarily meant that its Section 1 claim must also fail.

Also In This Issue

The BP *Deepwater Horizon* Oil Spill and Seafood Prices

David A. Argue describes how the approach used to model damages from the *Exxon Valdez* oil spill of 1989 could be used to estimate damages from the *Deepwater Horizon* oil spill in the Gulf of Mexico. In particular, damages may result from the effects of the Gulf spill on seafood prices. Several factors related to the *Exxon Valdez* oil spill had the potential to affect the supply and demand—and ultimately the prices—of Alaska seafood. In the *Exxon Valdez* study, a variety of supply and demand pricing models were used to estimate those effects. In evaluating damage claims from the Gulf spill, it may be necessary to use similar models to estimate seafood prices but for the spill.

The Two Faces of Credit Default Swaps

Jonathan A. Neuberger and Stuart D. Gurrea discuss credit default swaps and their role in the recent financial crisis. Credit default swaps have evolved from being primarily tools for hedging against credit risks associated with relatively simple debt instruments to vehicles with more speculative uses involving increasingly complex debt securities. Dr. Neuberger and Dr. Gurrea identify the risks associated with the broader use of these financial derivatives. They discuss how regulation might reduce these risks but might also restrict the beneficial uses of credit default swaps.

Measuring the Impact on Seafood Prices of the BP *Deepwater Horizon* Oil Spill

David A. Argue

The BP *Deepwater Horizon* oil spill in the Gulf of Mexico ultimately may cause unprecedented levels of commercial and natural resource damages. The *Exxon Valdez* oil spill in 1989 is often compared as the closest, if imperfect, historical example of how the Gulf spill will be treated. After the *Exxon Valdez* spill, fishermen claimed pure economic damages (now compensable under the Oil Pollution Act of 1990) related to alleged depression of seafood prices and to forgone catch in closed fisheries. To quantify such claims, estimates were made of the seafood prices that would have prevailed if the spill had not occurred. A study prepared after the *Exxon Valdez* spill undertook a comprehensive, multi-model estimation of price effects for twelve species of seafood in several fisheries at different levels of production. It based the estimation of price effects on the fundamental supply and demand forces that determine prices of Alaska seafood. This modeling approach could serve as a template for any estimate of price effects arising from the BP *Deepwater Horizon* oil spill.

The term "pure economic losses" refers to lost earnings that are unrelated to any accident-caused injury to the victim's property. In the context of an oil spill, pure economic losses might include the lost profits of fishermen barred from a contaminated fishery. No injury occurred to the fishermen's vessels, gear or other property, but they lost earnings in any event. More distinctively, allegations may arise that the accident reduced prices, thereby injuring even those parties who did not lose unit sales. Damage claims for price declines of this nature might yet be brought in relation to the BP *Deepwater Horizon* oil spill.

Although many types of accidents result in lost unit sales, only disasters are likely to have a large enough impact to affect market prices because they can greatly shift market supply and/or demand. An oil spill disaster may, for example, lead to the closure of contaminated fisheries, thereby reducing market supply enough to increase prices. At the same time, adverse publicity about the disaster may suppress demand from an entire region enough to reduce prices. The net effect on prices of changes in supply and demand conditions often are not obvious a priori, so an empirical study is necessary. The study of Alaska seafood prices used several empirical techniques and tested prices in different markets to determine whether seafood prices were abnormally low as a result of the spill.

EI Principal David A. Argue is one of the authors of The Economics of a Disaster: The Exxon Valdez Oil Spill, a book drawn from the study of Alaska seafood prices discussed in this article. A more detailed version of this article is available on-line at www.ei.com/publicationsonlinearticles.php.

Several factors related to the *Exxon Valdez* oil spill had the potential to affect the supply and demand—and ultimately the prices—of Alaska seafood. Supply was reduced by the closure of some Alaska fisheries for all or part of 1989. Supply may also have been restricted because Exxon employed many fishermen and vessels to help clean up the oil spill, diverting them from harvesting open fisheries. Both of these forces would have tended to increase seafood prices. Similar forces may exist in the BP *Deepwater Horizon* oil spill. For example, some Gulf fisheries were closed briefly and reopened, and others have remained closed. Early observations point to resulting increases in Gulf seafood prices. Demand-side factors were also at issue after the *Exxon Valdez* oil spill. One alleged factor was that the *Exxon Valdez* oil spill reduced overall demand for seafood from Alaska, thereby depressing the prices of seafood from both oil-touched and oil-free Alaska fisheries. The extent of the oil spilled from the BP *Deepwater Horizon* disaster and the vast news coverage it received may lead to similar claims about depressed seafood prices even for oil-free Gulf fisheries.

Many other factors unrelated to an oil spill could also affect seafood supply and demand. On the supply side, these factors include the number of fishing vessels in service, natural seafood population swings, weather events, and inventory levels. Among the factors that affect demand are consumer tastes, advertising, seafood quality, and foreign exchange rates. In modeling price effects attributable to a disaster, it is important to control for as many factors as possible. If the model adequately controls for the factors unrelated to the disaster, the impact of the disaster itself can be isolated with some degree of statistical confidence.

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The Two Faces of Credit Default Swaps: Risk Management Versus Speculation

Jonathan A. Neuberger & Stuart D. Gurrea

Financial derivatives have been identified as instruments that bear significant responsibility for the speculative boom and bust of the past decade, as they enabled speculators to place low-cost bets both for and against various sectors of the economy and even the economy as a whole. Among these derivative securities, credit default swaps ("CDSs") have been singled out as particularly troublesome instruments that fueled the housing bubble and facilitated the concentration of investor risk in housing-related assets.

Derivatives, of which there are many types, are financial instruments that derive their value from the behavior of other assets (typically called "reference" assets). Interest rate swaps, for example, involve an exchange of streams of cash flows whose value depends on absolute or relative movements in reference interest rates. Options, such as stock options, give the holder the right to buy or sell an asset at an agreed upon price before an expiration date. Futures or forward contracts consist of an agreement to buy or sell at a certain price at a future date. Credit derivatives, such as collateralized debt obligations ("CDOs") and CDSs, define payouts and value in reference to the performance of certain debt instruments.

In their simplest form, CDSs resemble an insurance policy – in exchange for paying a periodic premium, the CDS buyer obtains protection against the default of an underlying debt instrument (i.e., the buyer transfers credit risk to the seller). The CDS seller receives the premium and pays out only in the event the reference debt instrument defaults. The "price of protection," or the CDS premium, is based on the likelihood that the debt issuer will default on the relevant loan. The CDS seller typically is not the issuer of the debt, but is more often an investment bank or other financial institution. There also is no requirement that the buyer of CDS protection actually own the reference debt security.

The earliest CDSs were primarily "single name," i.e., written against a single reference corporate bond. In these instances, the triggering event for the CDS was clearly defined – the debt issuer had to be declared in default on the bond for a settlement payout to be triggered on an associated CDS. Over time, however, CDS contracts were written on increasingly complex debt instruments, including tranches of mortgage-backed securities, CDOs and other structured-finance products. For these securities, whose cash flows may be supported by thousands of bundled mortgages or other loans, credit risk is far more difficult to assess and a triggering event is far less obvious.

EI Principal Jonathan A. Neuberger specializes in financial economics, valuation, and damages analysis in complex commercial litigation assignments across a broad range of industries.

EI Senior Economist Stuart D. Gurrea has extensive consulting experience, including analysis of antitrust matters, calculation of damages, and performing financial analyses.

CDSs can be useful tools for managing and hedging risk. For example, an investor who holds a long position in a corporate bond may wish to protect itself against the possibility that the issuer will default on its debt obligations. By purchasing a CDS, the investor can obtain protection against an increase in the issuer's default risk. In effect, the investor uses the CDS to transfer some of the risk involved in holding the bond to the issuer of the CDS.

While CDSs can be used to manage portfolio risks, several features of these derivative contracts facilitate their use as speculative tools and may actually increase financial risk. CDSs are "over the counter" instruments, that is, they are customized contracts that do not trade on organized exchanges. As a result, there are no centralized parties (like an exchange) to provide transparency, monitor and control credit concentrations, or set appropriate collateral or capital requirements. Instead, a single CDS purchaser may be unaware of the CDS seller's other financial obligations. Thus, a seller could sell multiple CDS contracts on the same underlying debt instrument, regardless of its

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In the *Exxon Valdez* study, a variety of supply and demand pricing models were used. One model focused on changes in consumers' demand for salmon in Japan (the largest export destination) that would be consistent with demand suppression by the *Exxon Valdez* spill. The Japanese demand model was based on Japanese household expenditures and consumption of salmon. A second model estimated ex-vessel seafood prices directly using factors like inventories, harvest levels, food expenditures, and foreign exchange rates as well as variables for species, fishing gear type, and region, and a variable to isolate the spill effect. A third model considered seafood processor prices based on ex-vessel prices, quantities of seafood processed, and variables for species and region.

Benchmark comparison models were also employed, using statistical techniques to determine whether prices in oil-touched fisheries behaved significantly differently from those of oil-free benchmark fisheries. For Alaska salmon, fisheries in British Columbia were chosen as benchmarks because of similarities in fishing seasons, species caught, harvesting methods, and identities of wholesale purchasers and end users. For some non-salmon species, fisheries in northern California were used as benchmarks. Identifying specific benchmark fisheries for the BP *Deepwater Horizon* oil spill would require detailed research to determine the degree of similarity with affected fisheries.

Finally, the prices at which fishing permits in Alaska were exchanged were also studied. Not all Alaska fisheries required permits and the type of permit varied across fisheries, but permit prices could still be used to test for spill effects. Gulf fisheries that require permits could be examined in a similar fashion as long as information about permit transactions is available.

In the litigation that is likely to follow the Gulf spill, a variety of damage claims will need to be evaluated. Insofar as claims are made by fishermen for pure economic losses, it may be necessary to estimate prices that would have existed but for the spill as was done after the *Exxon Valdez* spill.

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financial ability to satisfy all of the promised payouts on these similar contracts in the event of a default. As a result, buyers of CDS protection face counterparty risk, i.e., the risk that a CDS seller will be unable to satisfy promised payouts. The ability to mitigate this counterparty risk by setting the appropriate collateral is further limited by the difficulties in valuing CDSs on complex debt instruments like CDOs.

There are also no requirements that the purchaser of a CDS (or the seller, for that matter) hold any position in the reference debt instruments. As a result, speculators can use CDS contracts to make directional bets on future economic activity. For example, many investors who turned bearish on housing markets in the 2005-07 period purchased CDS contracts on tranches of mortgage-backed securities, not to protect long positions they held in these securities but to bet against housing markets and rising home prices, activity that likely added financial risk rather than reducing or shifting it. Finally, there is reason to believe that CDSs actually may have prolonged the housing bubble by providing alternative ways to create additional mortgage-related assets. By 2005, the rate at which new subprime mortgage-backed securities were being issued had declined, even though there were still many investors willing to bet on continued increases in housing prices. A number of these investors purchased securities derived from CDSs that allowed them to increase their holdings of subprime mortgage-backed securities. These so-called "synthetic CDOs" ultimately enabled investors to hold positions in mortgage assets that were many multiples of the total amount of mortgage debt outstanding.

Financial reform legislation may address some of the potential problems associated with CDSs by standardizing derivative contracts and creating clearinghouses to increase transparency and limit counterparty risk, by restricting the ability to use CDSs for speculative purposes (for example, by requiring CDS holders to own the underlying debt instrument), or by limiting proprietary derivatives trading by banks. At the same time, however, these policies may be relatively blunt instruments that are unable to distinguish between the use of CDSs for risk management purposes and their use for purely speculative reasons. For example, standardizing CDS contracts offers the benefits of transparency and simplified collateral terms, but it may restrict the use of highly customized contracts designed to hedge unique risks. In addition, reforms that limit the overall use of CDSs may ultimately reduce liquidity in credit markets for both hedgers and speculators.

EI News and Notes

Aultman defeats monopolization and conspiracy claims

EI Principal Barry C. Harris testified at trial in Ohio state court on behalf of Aultman Healthcare. Aultman offers both clinical services and insurance products. Plaintiff Mercy Medical Center alleged that Aultman, through its insurance entity AultCare, overpaid insurance brokers to get them to steer customers to AultCare. Mercy further alleged that Aultman used this program to foreclose Mercy from patients and monopolize two hospital markets. Dr. Harris explained why Aultman's payments were a normal part of the competitive process. He showed that the amount of business associated with the AultCare payments was too small to have caused foreclosure or monopolization and that Mercy's performance was inconsistent with its claims. A jury found for Aultman on all of the antitrust counts. EI Vice Presidents Laura Malowane and Stephanie Mirrow assisted Dr. Harris.

Alpha Tire awarded damages

Plaintiff Alpha Tire claimed its designs for underground mining tires were unlawfully used by a distributor located in Dubai and a manufacturer located in China. Testifying for the plaintiff, EI Principal Philip B. Nelson presented evidence that the tire sales disclosed by defendants understated their true sales. He calculated profits that defendants would disgorge based on their disclosed sales and based on sales estimated using other defendant documents. The jury awarded the plaintiff $26 million in damages. Dr. Nelson was assisted by EI Senior Vice President Kent W Mikkelsen. Alpha was represented by Gilbert LLP.

California wins antitrust judgment

Recently the Ninth Circuit reversed a district court denial of summary judgment to the plaintiff in *State of Cal. v. Safeway, et al.* EI Principal J. Stephen Stockum was the economic expert for the plaintiff. The case involved a profit-sharing agreement among the major supermarkets in Southern California. The defendants argued that the agreement was necessary to prevent a labor union from targeting one supermarket chain at a time to win favorable terms in negotiations (so-called "whipsaw" tactics). The Ninth Circuit agreed with Stockum's testimony that emphasized that the redistribution of profits among defendants dramatically reduced the incentives to promote and discount supermarket products sold to consumers.

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