

CRA Competition Memo



Boeing/McDonnell Douglas

Competition policy was played out as melodrama last week when the *Boeing/McDonnell Douglas* merger was finally cleared. The Commission had a much better *competition* case than one might have supposed.

The case raised a key question in merger control, one we have dealt with in this series before: when is two suppliers enough? Like most interesting questions in competition economics this issue is *empirical* not theoretical. Without empirical analysis, economists' 'theories' and lawyers' 'arguments' tend to be just so much hot air.

A Bidding Study

In bidding markets it is often possible to study this critical question in a precise way. In the world-wide civil aircraft business there are about a hundred significant buyers of big aircraft (over 100 seats) and, until last week, three suppliers but now only two. This allowed a natural experiment to be carried out. Using historical price data, it was possible to estimate the effect of McDonnell Douglas Corporation (MDC) on the price paid for aircraft. We refer to this as a bidding study.

The underlying rationale of a bidding study is simple. If you are interested in the effect of Firm A on the price of a product in a bidding market, compare the prices paid when Firm A did not bid for the work against the prices paid when Firm A did bid for the work. If prices are lower in the latter case, this implies that the presence of Firm A in the bidding process imposes downward pressure on prices.

A study of 54 "campaigns", as they are called in the aircraft supply business, conducted in the last three years, revealed that the presence of MDC as a bidder had a significant downward effect on prices paid by airlines. MDC was a significant bidder in 20 of the 54 campaigns studied. On average, prices were 7.6% higher when MDC was not a bidder than when MDC did bid. This remained true — the result was stable — regardless of whether one controlled statistically for the size of the sale or for other

factors. For instance, when the size of the sale was accounted for, prices were still 5.3% higher when MDC was not a bidder than when MDC did bid.

Bidding Study: Three Bidders to Two

- 54 campaigns '94 - '96
- 20 with significant MDC presence ("triangular campaigns")
- Price effect of MDC overall 7.6%
- Price effect when big sales controlled for 5.3%

This suggests that the merger might be anti-competitive (although there are counter-arguments discussed below) because it was likely to reduce competition in civil aircraft markets and thus harm consumers.¹ That is, the effect of MDC leaving the market as an independent force would be to lead to higher prices for aircraft and hence to higher fares for consumers.²

What remedy is implied if the results of this study are correct? In order to restore competition to the previous level it is necessary that MDC bid as an independent company. This implies either that MDC's civil aircraft business be divested or that the merger be blocked. Instead, the Commission chose the lame remedy of insisting that MDC's civil aircraft remain legally separate for ten years. This is clearly not the same as MDC being a fully-fledged competitor to Boeing as there will not likely be independence of price setting.

Failing Firm?

The above analysis relies on the assumption that the future would have been similar to the past in

¹ Amazingly, the Statement of Objections in this case mentions consumers only once, and then only when dealing with sales of fighter aircraft to governments.

² This assumes that price setting in future would have been the same as in the past. As we detail below, there are reasons for believing that this may not have been so.

the absence of the merger. Boeing argued that this would not be the case, claiming that MDC was a failing firm and that no-one would ever buy MDC products again. The failing firm defence is a classic issue in antitrust but, as usual, there were problems making this argument convincing. The problem with all failing firm defences is that in many cases the consumer is better served by having a few more years of lower prices as the firm gradually fails. The key here is whether MDC was so weakened that it would no longer represent any downward pressure on prices.

The evidence suggests that MDC is not a failing firm in the classic sense. Even as a spares business it would be healthy, viable and profitable for some years to come. For its newest aircraft, the MD-95, the development costs are already sunk. There is an orders backlog for years of production work. There was simply no question of MDC exiting the market within the two-to-three year time horizon normally considered in merger analysis.

It seems that without the merger MDC would continue to be a declining civil aircraft firm, but that it would still be around to be the “maverick” player in bidding contests, thus keeping prices down. The failing firm defence was not convincing in this case.

Views of customers and competitors

Two further questions arise. If the bidding study is to be believed, why did Airbus complain and why did US customers of Boeing not do so?

The FTC voted on whether to sue Boeing under the US antitrust laws and divided four to one. In normal circumstances, a reduction from three firms to two in an industry, and a huge increase in the HHI, would certainly provoke an antitrust suit by the FTC. Why not here? Why did the FTC allow six to eight more years of prospective competition to be sacrificed?³ The FTC’s real problem was lack of customer complainants or, more specifically, lack of US airlines complaining. It seems that the majority of the FTC did not relish the prospect of trying to block a merger by America’s largest single exporter (Boeing) in front of an American jury when none

of the American customers would publicly say that he was unhappy.

Given the results of the bidding study, it is an interesting question why the US airlines did not complain about the merger. It may be that the US airlines had genuinely come to see MDC as a long run terminal case, but, equally, as the only source of very large aircraft (i.e. the Boeing 747), Boeing might not be a company that large airlines wish to antagonise. By contrast, several European airlines said that MDC did make a difference to price and that they would prefer that it not disappear.⁴

Similarly, why was Airbus complaining? If the bidding study is correct and prices would rise following the merger, surely this is in Airbus’ interests. Airbus believed and feared that Boeing would use its increased market power to predate against Airbus especially using offset deals on military aircraft produced by the big military arm of MDC. It was this fear presumably that prompted the Commission to demand accounting separation of the military and civil side of the combined Boeing/MDC.

Conclusion

Would this merger have been allowed through in another, more ordinary industry? A merger that took an industry from three to two players and in which there was evidence that the third player exerted a significant downward effect on prices would not often be allowed by the Merger Task Force. The evidence of the bidding study was that the merger should be blocked or that divestment of the MDC civil aircraft business should be imposed.

The actual result was a compromise making little economic or commercial sense since customers were not protected by it at all. But by the light of international politics it was all too easy to understand the result.

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³ This contrasts with the recent MMC decision on the Bass/Carlsberg-Tetley merger in the UK. Here the MMC effectively said that if indeed CT was failing, it was happy to let it fail and in the meantime keep it as an independent competitor in the market.

⁴ The number quoted by the Commission was eight airlines.