FEDERAL TRADE COMMISSION

I N D E X

June 24, 1997

FEDERAL TRADE COMMISSION

In the Matter of:)

HEARINGS ON THE)

JOINT VENTURE PROJECT)

Tuesday, June 24, 1997

Room 322

Federal Trade Commission

6th and Pennsylvania Avenue, NW

Washington, D.C. 20580

The above-entitled matter came on for hearing pursuant to notice at 1:35 p.m.

BEFORE:

ROBERT PITOFSKY, Chairman

JANET D. STEIGER, Commissioner

Federal Trade Commission

6th and Pennsylvania Avenue, N.W.

Washington, D.C. 20580-0000

ALSO PRESENT:

SUSAN S. DeSANTI, Director, Policy Planning

WILLIAM E. COHEN, Deputy Director, Policy Planning

LOU SILVIA, Bureau of Economics

WILLARD TOM, Bureau of Competition

MICHAEL McFALLS, Policy Planning Staff

SPEAKERS:

PAUL A. ALLEN

DAVID S. EVANS

RICHARD ROGERS

CHICKERY J. KASOUF

P R O C E E D I N G S

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COMMISSIONER STEIGER: Good afternoon. We are delighted to welcome our very distinguished group of speakers this afternoon. The chairman asked me to lead off with the first introduction. He will be here shortly. And we are going to hear first from Paul Allen, the Executive Vice President and General Counsel of Visa U.S.A., Incorporated, based in San Francisco. As such, he is responsible for legal and government affairs for Visa U.S.A. He joined Visa in 1991 as vice president and staff counsel.

From 1983 to 1991, he was General Counsel with Plus System Incorporated, a Denver-based joint venture of regulated financial institutions that developed the first global ATM network. Prior to that, he was a partner in a Washington law firm and specialized in antitrust litigation.

Mr. Allen, we very much appreciate your contributions for our record. Would you lead off for us?

MR. ALLEN: Thank you very much. My name is Paul Allen, Executive Vice President and General Counsel of Visa U.S.A. I commend the Commission for holding these hearings and I am certainly delighted to be here. My purpose in coming from California to Washington really is to urge the Commission to rethink in a very fundamental way the legal rules as they apply to joint ventures creating new, branded consumer products and services.

I want to state at the outset, that contrary to some of the speakers, we wholeheartedly urge the Commission to adopt guidelines in this regard because we think this will be fruitful and helpful, not only to the private bar, but to the judiciary as well.

The urging really is based upon Visa's rather robust history over the years. As you know, we have been engaged in numerous lawsuits over the years, challenging various actions that Visa has taken. We find in these actions a deep and pervasive government bias and legal bias against product-creating joint ventures that seems totally unjustified from the standpoint of productive efficiency or consumer welfare.

Indeed, if Visa were a unitary enterprise and had engaged in the number of activities that we have engaged in over the years, it would have been no serious question at all. Indeed, there would have been no litigation on many of these matters. But because Visa is a joint venture composed as it is with thousands of financial institutions, it is subject to a degree of legal scrutiny that simply does not occur with respect to either our direct brand competitors, American Express or Discover, or otherwise.

In short, it is structure, not behavior, that has defined our legal battlefield and we don't think that makes good legal sense, good economic sense, or is a consumer welfare enhancer.

What is Visa? Visa, as the umbrella organization, is the entity that overall defines a core product. We run the systems that enable the products to be issued. And we provide general advertising support.

However, the locus of competition in the credit card business with respect to Visa is not at our level, at the brand level. It is at the issuer level. And Visa has over 6,000 issuers in the Visa system. And those issuers, in fact, define all relevant aspects of the payment card product, whether it is ATRs, annual fee, or secondary benefits associated with the card. It is also the financial institutions that sign up the merchants to accept the card.

Now, why should that be different? Why should the legal rules with respect to behavior be different with respect to our organization, structured as it is, in contrast to, take a neutral example, not in our particular industry, Coca-Cola or McDonald's? Those happen to be for-profit organizations, which Visa U.S.A. is not. We are run as a not-for-profit organization. They happen to have a company. In the case of McDonald's, companies own stores as well as franchises.

Why should the law be different? Both Coca-Cola and McDonald's, when dealing with a variety of practices, could cite the Colgate doctrine for the proposition that they are free to decide whether they want to franchise.

They can cite GTE Sylvania with respect to territories.

They could cite trademark law with respect to potential compulsion from a trademark licensing point of view; Tampa Electric, for exclusive dealing, and whatnot.

And yet the law clearly is different with respect to joint ventures. And what I would want to share with the Commission very briefly, is three or four examples from our past, not to -- not as an attempt to engender any degree of sympathy for Visa -- we have been reasonably adept in defending our practices -- but to illustrate to you the kinds of practices that have been -- have caused us to be the subject of litigation, simply because we are structured as a joint venture, and are tested by joint venture rules.

Exclusivity. When Visa was first formed, there was an attempt to have both exclusivity and exclusive territories. That notion, 25 years ago, was challenged by a bank, the Worthen Bank. There was a trial. It was an Eighth Circuit remand decision. There was subsequent participation by the Department of Justice, which declined to issue a favorable business review. This was on behalf of a practice whereby -- Visa at the time wanted to have a system whereby a bank could choose to be Visa or MasterCard, but it could not do both.

Now, if Visa had been a public corporation, if this had been tested by traditional single-entity rules, as you will, and was not a joint venture, there would have been no legal issue at all. Indeed, Visa could have said to, in this case the Worthen Bank, no, this is the way we choose to practice, citations to Colgate.

With respect to pricing, it is necessary in a network such as Visa to make sure that the players have the right incentive to promote the network's products. This is true whether it is a payment card network or any other kind of a true network. Ours is an interchange network. We need to make sure that credit card issuers have the incentive to issue cards. We need to make sure that financial institutions that sign merchants have the incentive to sign merchants. That issue as well was litigated all the way up to the Eleventh Circuit. Although Visa won the case, it took four years and millions of dollars in legal costs.

Now, American Express, or AT&T, or Discover would not have had these issues at all had they chosen to franchise part of their system. Indeed, they would have simply, as they do today, had internal transfer costs to accommodate this. So again, we are subject to litigation, not because of the behavior, which in a different environment would not have been challenged, but simply because we are a joint venture.

Similarly, there has been litigation, as you may be aware, where several years ago Discover attempted to gain forced entry into the Visa system. This was a jury trial antitrust case in Salt Lake City after Discover had stated from the State House steps that they would deliver 4,000 new jobs to Utah. We lost the jury verdict. That was appealed in the Tenth Circuit, where we won.

Again, there would have been no issue had Discover chosen to go after American Express to seek a trademark license from American Express to issue American Express cards. That suit would have been eliminated on a Motion To Dismiss, regardless, even if American Express had had a large share of processed payment card transactions.

This was a case, by the way, that literally, we were subject to hundreds of millions of dollars in potential treble damage exposure had we lost the case. There are many other examples as well. Most recently, it is a matter of public record that we are dealing with an attempt by American Express publicly that is challenging the Visa rule that says that a Visa member, while licensed under the Visa trademark, cannot issue a branded American Express or Discover card.

Now, again, that would hardly create an issue were we a single unitary entity. Finally, a couple of years ago, we defended an antitrust case, when Visa had in place a rule that barred our member banks from levying surcharges or ATM access fees when a card is used at another member bank's ATM.

We were subject to a challenge in Federal Court on that antitrust price fixing. Again, we would suggest to you without getting into the nuances of the interpretation at the opening, that had that been considered a unitary enterprise, that the case would have been quite different. Indeed, it might not have been brought.

These are examples that really represent the tip of the iceberg, and they are illustrative of decisions that were made and defended, but they don't tell you about the numerous decisions that were foregone because of perceived antitrust litigation. In many cases, the risk may not have been great, but the business benefits were not great enough.

This is a meaningful loss, in our view, of business decisions that might have been made. These are really opportunity costs that a joint venture faces in competing with a unitary enterprise.

And there are many examples over the years where Visa has had to scrutinize in a fashion that would be unthinkable with respect to our branded competitors, Discover, or American Express. And I would suggest to you that the importance of this far transcends the payment card industry, but goes to other industries as well.

Now, in our written submission in August, we will go through and suggest four or five areas of particular attention that we would urge upon the Commission. But I want to say at the outset that I have been struck in reading some of the prior testimony of folks who say that well, there isn't really a problem. They think the rules are pretty clear, or that there needs to be no further clarification.

I would suggest to you, number one, that the rules are not clear. And that guidelines would be appropriate. And I would suggest number two, that in the course of drafting the guidelines, that we need to fundamentally, and I underscore fundamentally, rethink and not engage in kind of tinkering at the margins in the way the rules are applied.

Our written comments will therefore address four areas. Number one is structure. As a general proposition it is our view that one -- no one form of industrial organization ought to be considered a superior vehicle for entrepreneurial risk taking. The rules governing joint venture participation after formation should be limited to concerns about conduct not about structure.

Therefore, assuming the joint venture is not overinclusive when formed, its structural decisions concerning membership, fee sharing, should be limited by the essential facilities doctrine, and nothing more.

Secondly, while the per se rules of the pre-1977 era were worse, the rule of reason is still a source of immense uncertainty and hence deterrence, and I underscore deterrence, to a productive joint venture such as Visa. It is a Brandeisian Swamp, in the immortal words of Don Baker, in which everything is relevant, but nothing is dispositive. Outcomes are hard for counsel to predict and, you know, risks in our business inevitably lead to deterrence, to overdeterrence.

Third, Joel Klein's stepwise approach as described in his speech of a few months ago is precisely the wrong way to look at joint venture operations. He starts with efficiencies, which are notoriously hard to evaluate precisely and are rather like good cause concepts in employee wrongful termination cases, and then he turns to competitive effects. That is precisely backwards. And when applied to the hundreds of decisions that a joint venture must make every year, it will add nothing but difficulty and indeed, will have an overdeterrent effect.

And finally, the inside, what we characterize as the inside decisions of a product-creating joint venture, ought not to be subject at all to these cartel-flavored agreement principles or concepts under the Sherman Act.

A joint venture should be as free as a single firm to set network incentives such as interchange fees, in our case interface standards, advertising requirements, free-rider types of prohibitions and anti-fraud standards for members.

In other words, a joint venture should not be subject to second-class treatment vis-a-vis a unitary enterprise such as in our case, whether it is American Express or Discover, or in another -- in another particular business. A joint venture would be subject to Section 2 type rules for certain exclusionary inside decisions that are supported by substantial market power, but other than that, the rules ought to be the same for unitary enterprises and for joint ventures.

Now, this is not a particularly remarkable proposition, I don't think, for us to advance. It's grounded in the common sense notion that absent some compelling reason, the form of the competitive entity, the form of the entity should not control the legal analysis to which it is subject. With respect to guidelines, we think the Commission has the opportunity here to take a leadership role to articulate guidelines that would be useful to the bar.

Again, I know some have come in and said, we think from the standpoint of outside counsel the rules are perfectly clear. All I can tell you, as an individual who has been in the antitrust game a long time, who has been in the payments card joint venture game for over 15 years, additional guidance would be important, particularly if you are to attempt to move beyond the hostility in the law to joint ventures.

It could be useful to the bar and it could be particularly useful to the judiciary.

Fundamentally then, in conclusion, I ask the Commission to take a serious look at these matters and to try to restore to joint ventures the competitive vitality that joint ventures have the opportunity to deliver into the marketplace. They should not be treated as second class citizens under the antitrust laws, and I think the Commission can make a considerable step in that regard.

I thank you for your time.

COMMISSIONER STEIGER: We thank you. I do have a question referring to page 11, on your conversations with the extraordinarily distinguished Philip Areeda, encouraging overinclusion in existing joint ventures, rather than encouraging competition.

Some of those who have favored an attempt by this Commission to draft some joint venture guidelines, have also spoken in favor of safe harbors.

Do you suggest to us that there should be some kind of safe harbor on the question of inclusion in existing joint ventures, and if so, how would you suggest that the Commission proceed and what is the role then of market share?

MR. ALLEN: Well, I know that the guidelines have since been withdrawn, but the guidelines for international operations were extremely helpful to Visa, have been helpful to Visa in setting forth how the government would look at the question of inclusiveness versus overinclusiveness or not.

Now, those guidelines were indeed recited in the Tenth Circuit case involving Dean Witter Discover. And we found those guidelines to be adequate from our point of view with respect to that particular issue. If safe harbors could be articulated, that would be -- that would be fine. I'm inclined to share the view of others who have questioned that in certain circumstances, whether they indeed would be too much on the conservative side, but I guess the short answer would be that the international guidelines we found to be extremely useful and we would urge something like that to be set forth.

COMMISSIONER STEIGER: Thank you. I know others have questions.

MS. DESANTI: Yes, I have a few questions. In talking about structure and the different treatment for joint ventures, as opposed to say a franchise or a franchisee relationship, I'm assuming that Visa must see some particular benefits in being formed as a joint venture as opposed to some other type of corporate relationship. And I was wondering if you could give us some explanation of why initially BankAmericard was formed as a joint venture? What are the business reasons that were driving you to use that form?

MR. ALLEN: Sure, let me indicate even in today's Wall Street Journal they had an article inside about the formation of a new communications provider, that in the article, mentioned that they were modeling themselves on the Visa joint venture, which I found rather interesting.

When Visa was first formed, of course, in the early 1970s, the world as we know it today was rather different from the standpoint of financial institutions, but I think the genesis of the joint venture form was the same one that would cause other entities today to form joint ventures, and that is, you want to be able to deliver into the marketplace a product or service that you alone cannot deliver and share risks, share investments, engage in conventional partial integration, if you will. Visa was able to put, to enable our individual financial institutions, which at that time we had probably 20,000, to put into the marketplace a product that enabled the smallest independent bank to compete head to head not only with Citibank or First USA, but to compete with a brand competitor such as American Express. Discover didn't come along until the 1980s.

That is an example of how the joint venture structure can enable a participant in the venture to compete to a degree and to a magnitude that otherwise would have been unthinkable. Now, you know, are there other ways in which the organization could have been formed? Sure. But even today, Visa, although we are a joint venture, we participate in joint ventures. We have joint ventures with other parties, 50/50 type arrangements. But from a business point of view, we go through precisely the same internal business planning analysis. What are your goals? What are your financial goals? What are you trying to accomplish? Is its integration going to enable you to accomplish those goals sooner in a more plausible, productive manner?

MS. DESANTI: As a follow-up, let me ask you about your argument that you are urging the FTC and others to rethink a view of joint ventures under the antitrust laws. Your arguments to some extent go to very basic threshold issues of whether you are going to treat single-firm activity or activity agreements among competitors differently than single-firm activity.

I'm wondering whether you are reaching that conclusion because there is some fundamental rethinking that needs to be done for the antitrust laws, or whether because -- it's because Visa in particular is bumping up against some of the most difficult issues that arise in that context, and typically those issues have involved decisions about pricing or output in the area where you have a partial integration, but it is an integration that involves joint pricing, joint sales, joint marketing. That's one possibility.

Other areas where there have been difficulties are areas of networks where you have both competition within a network and competition between networks and that also seems analogous to your situation. And you in your testimony have brought up the issue of having branded product, and the special requirements for marketing a branded product.

I'm wondering if out of those three types of areas that can produce very knotty antitrust issues, there is one that sticks out in your experience as more difficult than the others, or whether all three are particular sources of difficulties when you consider the different types of business conduct that Visa might want to engage in?

MR. ALLEN: You have covered a lot of territory.

MS. DESANTI: Yes.

MR. ALLEN: Let me respond, number one, that our recommendations clearly are recommendations that we think are going to be of some benefit to Visa. We also think that they will be of benefit to competition generally, and to consumers generally, because -- and this gets I think to your point -- whether we like it or not, Visa has often been at the cutting edge legally of some of the most difficult issues in antitrust and joint ventures.

We have hit those issues earlier than most others have hit those issues. We see the effect internally of being tested by a legal regime that when you compare it again to the unitary enterprise seems disconnected, if you will, from consumer welfare arguments, from productive efficiency. What is the logic -- taking the Visa model for just a second -- what is the logic of treating Visa fundamentally differently with respect to our behavior, vis-a-vis American Express or Discover, and the easiest example I can use is the Discover attempt to get the compulsory license for Visa. And I don't want to belabor that point, but I think that is an example.

Now, the implication of that for commerce generally, I think, is that if we as a joint venture are bumping up against these issues, we are doing so partly because, in my view, the credit card is virtually ubiquitous. Visa has difficulty partly because the credit card is so obvious to consumers, so obvious to folks in this building and in adjacent buildings.

And I would suggest to you that the issues that we face in terms of behavior are not unique to Visa; that there are other organizations whose behavior may be affected in an overdeterrence sense by virtue of these principles. More broadly, I think we need to move beyond, not only the rather ambiguous nature of the law today, in the Brandeisian Swamp as I characterized, but I think we need to move considerably from that. We have to ask hard questions.

Do we as a matter of government policy -- and I would concede this is a policy matter -- want to place a particular form of industrial organization at a disadvantage in the eyes of the law simply because the folks who formed that organization had decided to set it up that way, rather than as a unitary enterprise. And I think those are the issues that we need to -- need to be addressed.

MS. DESANTI: I don't want to monopolize. I just have one quick follow-up with him.

Your testimony describes competition that occurs within the network. Is that correct?

MR. ALLEN: Correct.

MS. DESANTI: And am I correct in interpreting your testimony as saying that antitrust law should not evaluate whether any of the actions taken by Visa might reduce competition that takes place within the network?

MR. ALLEN: No, no, I am not.

MS. DESANTI: Okay, then help me understand this.

MR. ALLEN: No, I am not and we will elucidate this in our written submission. What I am suggesting with respect to so-called quote unquote inside decisions, as articulated in one of Posner's articles, is that inside decisions with respect to that entity should be treated in the same manner as inside decisions are treated with respect to unitary enterprises.

For example, membership, basic membership issues, free-rider types of concerns. Those are the kinds of rules where Visa may be subject to a Section 1 challenge, whereas a unitary competitor would not be. We say why the difference in treatment? Clearly, with respect to other manifestations of behavior would be exclusive, certain forms of exclusive territories, or whatnot, whereby a franchisor, even set up as a unitary enterprise, would be tested by these principles. We are not saying those principles should differ with respect to Visa, but we are saying there is a body of inside activities that ought to be within the domain of the entity, and should not be subject to a Section 1 challenge.

COMMISSIONER STEIGER: I believe Will Tom was the first.

MR. TOM: A previous witness at these hearings suggested that most of the principles we need for joint venture analysis, are found in the intellectual property guidelines, and I suppose if you applied those guidelines to the question that you raised, why should the joint venture be treated differently from the unitary enterprise, it would go something like this: If you are dealing with a joint venture whose members would not have competed, would not have produced the product, absent a venture, then you are really talking about a vertical relationship. You are not talking about a relationship with the competitors and therefore, you shouldn't be concerned about things like joint pricing.

If anything, you should be concerned about their traditional vertical issues, exclusionary behavior, rising costs, facilitating inclusions with other ventures, things of that sort.

But on the other hand, if you are dealing with a supposed joint venture that would have been competing in that very market, absent the venture, don't we have to treat that venture differently from the unitary enterprise? Don't we have to have greater and traditional horizontal concerns about that joint venture?

MR. ALLEN: Well, you know, consistent with my prior response, there will always be an area -- we are not suggesting that as a matter of policy we should move away. There will always be an area where the joint venture may pose special and unique questions that wouldn't be posed by the unitary enterprise.

However, however, the law for so long -- as we all know -- the law for so long has disfavored joint ventures, precisely because everything is deemed, indeed is presumed, to carry the cartel baggage; that folks aren't going to get together to form an enterprise for this reason unless they had something pernicious in mind.

And what we suggest is that the American economy has moved way beyond that. And we may be at the kind of point that we were at several years ago, when you had PPOs that were popping up to attempt to compete with the HMOs. Now, that is a bit of an analogue. An HMO is a unitary enterprise. Kaiser was running for quite some time and didn't have to face the kind of questions that Visa had to face. And then you had competition coming up from individual doctors or hospitals who wanted to get together to combine to compete with Kaiser, and ultimately there were health care guidelines which have safe harbors and articulate a logical way in which these practices are going to be looked at.

Now, I mean, I would suggest to you that not only might that serve as a useful starting point, in candor, I'm going way beyond that. I'm saying that with respect to many of these joint venture types of areas, you need to really fundamentally rethink whether this conventional rule of reason analysis should at all apply with respect to some activities, some of these internal activities of the entity, be it corporate, be it unitary enterprise, or a joint venture.

COMMISSIONER STEIGER: Yes, Mr. Silvia.

MR. SILVIA: I guess the thrust of your testimony is that a joint venture like Visa is competitively hobbled in a sense, relative to unitary entities that Visa competes against. And I think you did allude to foregone business decisions that Visa had, but just to turn this around, can you identify in specific, or even general, marketplace strategies on investments that the unitary enterprise competitors of Visa have undertaken that Visa was not doing because of this unequal treatment?

MR. ALLEN: Marketplace strategies?

MR. SILVIA: Yes. What I'm getting a sense is that, I understand strategic litigation problems that might arise, but I'm thinking of this in terms of competing in the marketplace. If indeed the joint venture was hobbled competitively, I would expect to see some differences in behavior between unitary enterprises and joint ventures in terms of behavior in the marketplace. Help me out with that.

MR. ALLEN: Well, first of all, I'm not suggesting that Visa has been hobbled. I never really used that term. But what I am suggesting is that over the years Visa has routinely faced challenges; that those challenges have led to an opportunity cost; that they have led to overturns within the Visa system. We have had to confront those challenges when our two brand competitors have not had to confront those challenges. So that is number one.

Number two, you must recognize, again, that the locus of competition with respect to the consumer is at the card issuer level, the financial institution level. A number of these additional cards set the financial and non-financial fees with respect to that product. But there are a host, if you look back at our litigation history, and very, very few of those, rightly or wrongly, seminal cases could have -- would have been brought against our brand competitors.

And we say that, not because we are here necessarily because the world should be reengineered to fit Visa, but we say that at a time when joint ventures are increasingly important to the economy. Again, what is the fundamental logic of, above and beyond the Adam Smith kind of bias, what is the economic fundamental logic for subjecting the joint venture to a higher legal test than the unitary enterprise who otherwise might have precisely the same product? And indeed, why should those who are formed as joint ventures apparently bear the burden of having that law changed?

Indeed, it seems to me that the burden ought to be on the other side, that if there is to be second class citizenship for joint ventures, it ought to be up to the unitary enterprise to say why that ought to be the case. And again, with respect to certain kinds of activities, inside decisions, and others, we'll comment on that in our paper, we just don't see the logic in that.

COMMISSIONER STEIGER: Thank you.

MS. DESANTI: I have one more question. Could we just go back for a moment? I think it is -- I'm wondering whether it may be an overstatement of the point that you are trying to make to us, and I'm pursuing this because I want to try to clarify the record, to say that there is no logic for treating joint ventures differently than single firms.

Clearly, if joint ventures involve agreements among competitors, that may reduce competition that otherwise would have taken place, there is some logic for treating joint ventures differently. But in trying to get at a better understanding of what you are trying to convey to us, I'm wondering whether your point isn't more along the lines that when, for instance, Visa has rules that affect the competition that occurs within the joint venture among the members, the issuers, in your case, that you are saying that's an area that is properly of antitrust concern, versus when you are simply looking at how the joint venture, Visa, competes with other joint ventures and individual companies, then that is an entity that should be treated as a single entity. Am I --

MR. ALLEN: Correct.

MS. DESANTI: Am I getting anywhere near what you are trying to say?

MR. ALLEN: I think that is exactly right. If we could give just one small example. Visa, I assume other payment brands are the same thing, look at the merchants in the system from time to time with respect to fraud issues. I mean, we need to keep track if there are merchants that have extraordinarily high -- extraordinarily high level of fraud occurring in a particular merchant location, we as a system can flag that, we can identify that. We can talk to the financial institution and say hey, you may have a problem here. We have found -- and I'm not going to go into too much detail in a public forum for obvious reasons -- but what we have found is that Visa is subject to antitrust cases.

In our view they are cooked up antitrust cases, but they are antitrust cases nonetheless that are really grounded upon the nature of these as a joint venture in circumstances where we attempt to control that kind of behavior.

Now, I dare say, when one of our brand competitors that is a unitary enterprise attempts to address that problem, there is no antitrust issue posed that I can think of. That is just one small example. But there are many others as well, where from the standpoint of inside counsel, from the standpoint of business people, you tend to scratch your head and say, why should this be different?

MS. DESANTI: Thank you.

MR. COHEN: Just one question. I understand your feeling on some fundamental rethinking of perhaps the rules in Section 1 and Section 2 here, but if we end up with something less than that, I'm wondering if you could comment either now or in your forthcoming written material as to how we might try to -- how you might suggest we could perhaps refocus our thinking or clarify our thinking to still give any significant comfort to Visa short of this fundamental change?

MR. ALLEN: Well, we will address that in our written submission. I can say that off the top of my head, that in our view, again, contrary to what others have said, we don't think that the intellectual property guidelines are, alone, enough. If I were in the health care business, if I were a general counsel for one of the health care companies, a PPO, you know, like it or not, at least I would know the way the government is going to address these issues and I could look at the Health Care Guidelines.

When faced with a potential plaintiff, I could point that potential plaintiff to the Health Care Guidelines. When I was in court, I could point a judge to the Health Care Guidelines. I have none of that right now. So from the standpoint of this particular company, I can tell you that some guidance would be better than no guidance. Indeed, as I alluded to previously, in my view the guidelines for international operations were very helpful to Visa from the standpoint of internal guidance and internal counsel. That was very beneficial. And at least that was something, number one.

Number two, as I indicated in my written comment, we think that if nothing else, that the guidelines if issued, hopefully, would take issue with Mr. Klein's characterization because as I have indicated, we think his two-step approach is precisely wrong, is going in the wrong direction despite the nonetheless worthy goal of attempting to simplify analysis for the bench and the bar.

COMMISSIONER STEIGER: Thank you very much, Mr. Allen. We will hear now from Dr. David S. Evans, Senior Vice President of the National Economic Research Associates, commonly known to all of us as NERA.

Dr. Evans' primary areas of interest include industrial organization and antitrust economics, and he has worked on several major antitrust cases, including DOJ's cases against AT&T and IBM and recent litigation between Dean Witter and Visa. He has conducted many studies on a variety of issues, including predatory pricing, the effects of mergers, market definition, and evaluating market power. Before he joined NERA, he was an Associate Professor of Economics at Fordham University and Adjunct Professor of Law at Fordham University Law School, where he taught law, economics, and antitrust economics.

Previously, he was a Senior Research Associate at Charles River Associates, where he worked on antitrust and public policy studies. He is a member of the American Economic Association, the Econometric Society, the American Statistical Association and the American Bar Association. And the Commission thanks you very much, sir, for your contributions today.

DR. EVANS: Well, thank you very much for having me here today. I'm actually testifying today on behalf of not only myself but also Richard Schmalensee. Dick, as some of you may know, is a Professor of Economics at MIT and an Associate of the Sloan School. He and I had both consulted and testified on several antitrust matters for Visa over the past two years. Because matters have often hinged, as Paul suggested, on the fact that Visa was a joint venture, we have had the opportunity to think about the antitrust analysis of joint ventures and the rules that they adopt.

But I would like to get beyond the specifics of Visa today and share with you our thoughts on some general principles that we believe should guide the antitrust treatment of joint ventures. And I would like to discuss how those principles should be applied in a structured rule of reason analysis.

And then I would like to comment briefly on some recent proposals to impose a heightened level of scrutiny on joint venture exclusionary rules. I apologize for not having a paper today. It has kind of taken on a life of its own, and I expect to have something completed in a couple of weeks to share with you.

Let me start with the principles. I have three for you. Antitrust policies should neither encourage or discourage entrepreneurs from choosing the joint venture form of business organization over other forms.

Second, antitrust policy should recognize that joint ventures face different management and coordination problems than single firms, and they adopt practices to deal with those problems.

And lastly, antitrust policy, obviously, should prevent joint ventures from circumventing the antitrust laws. Let me elaborate on this.

Our first principle is that antitrust policy should not bias the choice of organizational form. Economists don't really have any empirical or theoretical reasons to suggest that entrepreneurs are starting joint ventures to skirt the antitrust laws. So we'd really like entrepreneurs to choose the most efficient vehicle for their endeavors. Now, that might be a closed joint venture, it might be an open joint venture. It might be a single firm. It might be a merger of firms. It might be something entirely different.

To ensure neutrality of choice, we have to pay, I think, some attention to how joint ventures are treated under the antitrust laws. That treatment has a feedback effect on the formation of joint ventures in the first place. To the extent that the courts condemn certain types of joint venture practices, the expected costs to actual or prospective joint ventures of adopting those practices -- or practices that can be construed as similar, would increase. I mean, it's hard to imagine, for example, that Topco and Sealy in their time, at least didn't discourage some efficient joint ventures from coming into being.

To keep the choice of organizational form unbiased, we should try to treat joint ventures like single firms as much as possible. Now, this principle is especially important because joint ventures are fragile organizations to begin with. One study found that only 50 percent of high technology alliances survived four years. Another estimates that over 60 percent of alliances failed and it is easy to see why.

Joint ventures face lots of problems. It is hard to resolve conflicting objectives by participants. There are culture clashes and so on. And the failure of the Teligent/Kaleida joint venture, the one between IBM/Apple, illustrates exactly those kind of problems. And that brings me to the second point.

Antitrust policy needs to recognize that joint ventures have to solve very complicated management, organizational, and incentive problems by rules. Single firms don't have those problems, or they solve those problems through internal policies that we just don't observe.

In particular, I think there were four problems that I would like to bring to your attention. First of all, joint venture members may have conflicting objectives. Members may want to push the joint venture in different, possibly opposing directions.

Second, joint venture members may attempt to free ride on the efforts of other members, or they may impose negative externalities on each other.

Third, the joint venture has to harness its members to generate positive externalities and to harvest scale, scope, or network economies.

And finally, the joint venture has to coordinate the actions of its independent members, and that consideration is really important in network industries as is Visa. Now, joint ventures generally adopt two kinds of rules to deal with those problems.

There are structural rules that determine membership and distribution of voting rights in the organization. And those kinds of rules help maintain organizational cohesiveness, they police free rider problems, and they increase the realization of positive externalities.

Operational rules determine how the joint venture and its partners work with each other. These rules help joint ventures solve coordination problems. In addition to that, they also police free rider problems and increase the realization of positive externalities.

Now, of course, actual management problems faced by joint ventures are often very, very particular to the circumstances of that venture. The particular problems would depend upon the industry in question, would depend upon a joint venture's goals, the joint venture's structure, the personal dynamics of the venture's members and many other factors. We therefore need to be more careful about questioning whether particular practices adopted by joint venture members, by joint ventures, are reasonably necessary.

It is real easy for outsiders to think of alternative less anticompetitive "means" to solve a particular organizational set of problems. It is a quite different matter to actually show that these externally designed solutions will work in our world.

Actual joint venture practices at least have the appeal of having been designed by people who actually run businesses. That is at least one reason why I think it would be a really bad idea to place the burden of proof on joint ventures to establish that any particular rule generates efficiencies, or to establish that their rule is the best way of achieving those initiatives. And that's one of the reasons that I would disagree with Joel Klein's approach.

Now, we are not advocating laissez-faire for joint ventures. Joint ventures provide an institution through which competitors meet and agree on matters of mutual interest. Like trade associations, meetings in smoky hotel rooms, and plain old mergers, a joint venture can provide a vehicle for harming consumers. So that brings those -- brings me to our third principle.

Antitrust laws should prevent joint ventures from engaging in anticompetitive activity that would have been prohibited if the entrepreneurs and investors in the joint venture had chosen some other way to organize themselves.

Now, a corollary to that principle is that the determination of whether a practice is anticompetitive or not usually should really not turn on the fact that we are looking at a joint venture. Now, nonetheless, there are differences between joint venture firms and, to take one example, merger of the same firm. For one, the joint venture may provide different efficiencies than a merger. At one extreme, if the joint venture partners don't consolidate production facilities, they may not realize some economies that a true merger would. At the other extreme, the joint venture partners may realize network economies from joint production without being saddled with diseconomies resulting from merging unrelated operations.

To take a final reason, the joint venture may adopt rules that provide for extensive price competition among members. Now, the joint venture may engage in joint production without necessarily engaging in joint pricing.

And in that case, there are efficiency benefits and that should be both the beginning and the end of the story.

So those are the principles. With them in mind, I would like to suggest that we subject joint ventures to a three-step rule of reason analysis. First, does the structural or operational rule raise the price or reduce output or otherwise harm consumers significantly? If not, it is legal, because regardless of intent or efficiencies, the rule can do no harm. If yes, we move on to step two.

Step two says: Does the structural or operational rule contribute to the production of important static or dynamic economies that could not be readily achieved by an obviously alternative arrangement with no anticompetitive potential? If no, it is illegal, since it has no countervailing benefits to offset consumer harm, identified in step one. If yes, we move on to step three.

And having reached that step, the finder of fact must balance anticompetitive cost against procompetitive benefits as both of those have presumably been detected in the first two steps.

Now, this approach is more or less consistent with Chairman Pitofsky's classic treatment of joint ventures. I think it differs in the emphasis. We focus more heavily on the ex ante effect of ex post rules. We also suggest that the efficiency analysis recognizes that running a joint venture is just fundamentally different from running a single firm.

Now, in conducting that rule of reason analysis, it is important to distinguish, again, between operational rules that result, for example, in price fixing and market division, and structural rules that define participation in the joint venture. The antitrust treatment of horizontal restraints provides a useful framework for considering operational rules. For example, economic theory generally predicts that price fixing and market division will harm consumers, at least in the short run. So the only justification for those kinds of rules would be either that they are necessary for the joint venture product to be made at all, sort of a BMI situation, or that the joint venture has to fix prices to earn adequate expected return on its risky investment.

Now, if competitors form the joint venture and fix the price of a product that those competitors were previously selling independently, that is all that was going on, we have little trouble reaching a quick condemnation of the joint venture under step one of the analysis.

Now, the antitrust treatment of mergers, refusals to deal, and essential facilities, provides, I think, a very useful framework for considering structural rules. And for example, let's take membership restraints. Economic theory suggests that there are sound reasons for limiting membership in a joint venture.

Membership restrictions may provide a way to police free rider problems and maintain cohesiveness. Second of all, membership restrictions are often intimately intertwined with the definition of property rights by the joint venture.

And third of all, at the same time, economic theory provides no a priori for believing that membership restrictions will harm consumers. In that respect it is very different from price fixing. We have economic theory that says price fixing is going to harm consumers. Membership restrictions, we just don't have an economic theory that predicts an a priori basis for believing that.

So to answer one of the questions that was raised before, yeah, I would have a safe harbor. We would generally allow joint ventures to refuse to admit new members. Doing otherwise would result in joint ventures having more poorly defined property rights than single firms. And there is no reason that I can think of for handicapping joint ventures in that particular way.

Now, indeed, to the extent that there is much controversy these days over the antitrust treatment of joint ventures, it seems to center around the right of joint ventures to exclude members. That, of course, was the issue in the MountainWest case. Dean Witter wanted to become a

Visa member. Visa didn't want a competitor sitting at the dinner table. Of course, Dean Witter operated the Discover card. Now, the Tenth Circuit ultimately sided with Visa. Since then there has been an outpouring of law review articles by lawyers and economists associated with Dean Witter. At last count we had four major articles with seven authors on the topic. For a case that didn't involve either sex or murder, the volume of post-verdict prose is really quite remarkable. The articles suggest various rules that would make it hard for a joint venture to exclude members. And there are several articles here, but just to kind of pick on one, I'm going to pick on Carlton and Salop's piece in the Harvard Journal of Law and Technology.

They don't think the joint ventures should have the same property rights as single firms because joint ventures can be used as a vehicle for suppressing competition. I think there are at least two problems with that particular view.

First, joint ventures, like single firms, can suppress competition. On the other hand, joint ventures, like single firms, can also provide a sufficient vehicle for producing new goods and services. In both cases we prefer to deal with anticompetitive problems directly; not through favoring one particular organizational form over the other organizational form.

Second, once you decide to disfavor joint venture property rights, which I think that approach does, it is really hard to know when to stop. Carlton and Salop at least pretty much ignored the property rights on the formation of efficient joint ventures. They just focus on the short-term benefits and costs of the exclusion.

Now, that myopia is made worse by their casual dismissal of the costs of the overinclusiveness. They say that if expansion of a joint venture would diminish competition, the existing members of the joint venture should favor that kind of expansion. And I think that is too strong for a variety of reasons, but it is also odd, given that these authors would impose a higher level of scrutiny on bigger joint ventures.

As much fun as litigation is, we would think that a joint venture wouldn't necessarily want to invite that additional scrutiny. In fact, that is one of the arguments we see in the MountainWest case.

Now, these authors would also require joint ventures with "collective market power" to admit new members unless the joint venture could establish an efficiency justification for refusing to do that.

Now, that's the rule that the plaintiff advocated in the MountainWest case, and it's the rule that the Tenth Circuit, I think quite properly, rejected. That rule would condemn denial of access by a joint venture with a large collective, add up the share of all of the members' market share. And it would do so regardless of the intensity of competition among the venture's members, and even if no harm to competition or to consumers could be demonstrated. That is, unless the venture could somehow meet the very difficult burden of establishing efficiency or competitive justifications, most of which Carlton and Salop have essentially ruled on in the article. We just don't think that there is any basis in economic theory, or in our empirical experience that we have with joint ventures, to disfavor the joint ventures in that way.

Now, in conclusion, despite this particular controversy, there is actually a fair amount of consensus on how to think about and to treat joint ventures in the literature. There seems to be a general agreement now, that only the most naked horizontal restraints -- pure price fixing among unintegrated horizontal competitors -- should be treated as per se illegal. The courts more or less came around to that view by the early 1980s.

Most commentators now seem to agree that joint venture practices should generally be treated under the rule of reason analysis. Many writers also recognized the importance of free riding and other efficiency explanations for joint venture actions.

Several authors recently seemed to recognize that antitrust policy towards joint ventures can have very profound effects on the incentives to start welfare-enhancing joint ventures in the first place.

And finally, although the judicial treatment of joint ventures isn't exactly a model of doctrinal clarity, by and large the courts have done a pretty good job, I think, of eventually -- and I know Visa doesn't like the eventually aspect of that -- but eventually separating procompetitive from anticompetitive joint venture practices in particular cases.

We would like to suggest, though, that the principles I discussed today would do two things. First, I think they would enable the government and the courts to screen joint venture practices a little bit more efficiently. And secondly, they would provide business with a high degree of certainty about the legality of the particular joint venture rules. Thank you.

COMMISSIONER STEIGER: Dr. Evans, thank you. We are all going to look forward to receiving your completed paper, but I must say it is hard to believe that you could improve on the precision and the breadth of your comments here today. Thank you. I'm sure there are probably questions. That sounds pretty much to me like a Mass Board analysis. How would it differ?

DR. EVANS: I have not read Mass Board. My apologies.

COMMISSIONER STEIGER: You sure you didn't write Mass Board?

(Laughter.)

COMMISSIONER STEIGER: All right. Then we will welcome back again, Mr. Rogers. He is appearing on behalf of the National Association of Manufacturers, where he chairs the Competition Subcommittee. Mr. Rogers is counsel for antitrust and public policy at the Ford Motor Company, where he handles antitrust matters, including antitrust compliance. Before joining the board in 1978, Mr. Rogers was in private practice in Chicago. He is a member of the Business Round Table and the Antitrust Lawyers Advisory Committee, and again, we thank you for your presentation.

MR. ROGERS: Thank you, Commissioner Steiger. I am appearing on behalf of NAM today, which, as you know, has 14,000 members. I will be delighted to entertain whatever questions you may have. But given the scope of your agenda for today's meeting, it may be that my views necessarily reflect my own experience or my own opinions and when that happens, I will try and indicate that.

We followed the same methodology at NAM for today's testimony that we followed in the '95 hearings on antitrust in the global economy. We had a subcommittee meeting; we discussed the issues; I did a draft of the testimony that was circulated to the subcommittee members for comment, and what I present to you by way of prepared remarks is a consensus view. Those on my subcommittee represented a variety of industries, including motor vehicles, pharmaceuticals, oil and gas, telecommunications, consumer electronics, steel, construction equipment, and forest products.

We had no question at all in our subcommittee that joint activity among competitors, or competitor collaborations has substantially increased over the years. Of course one reason for that is the law has changed substantially. When I came to Ford, one of my immediate predecessors was referred to as Dr. No. And the reason for that was that whatever restraints you came in with, whether horizontal or vertical, it was either per se unlawful or involved substantial antitrust risks. And perhaps that was an overreaction, but not much, to the law at that time.

With the incentives of the rule of reason, there has been injected a certain element of uncertainty, but also a great deal of flexibility.

So that over time, competitive collaborations are much safer from a legal point of view. I think from my own personal point of view, and that in my industry, the watershed for joint ventures was the approval of the General Motors/Toyota joint venture in 1984. Those were and still are arguments of the two most powerful auto companies and they were permitted, we think quite properly in retrospect, to form a production joint venture, although the marketing and the pricing of the products produced there was kept entirely separate.

Also, Congress sent a very powerful signal to our clients, the business people, in passing the National Cooperative Research Act, which was amended later on to cover joint production. They sent the message that joint activity is not only acceptable, but may even possibly be encouraged.

The regional motivations are still there. The joint activities can generate economic efficiencies. They can reduce risk, and cause a sharing of costs. We think particularly important in today's economy, is the continuing pressure in virtually all industries to do more and more with less and less. And that is largely in response to global competition, although to some extent, domestic competition too.

One of the ways that one does that is by sharing scarce resources and that has been a very powerful motivator in all of the industries on the subcommittee for joint, as opposed to independent activity. And I will elaborate a little further on that later on. We think that is a continuing pressure. The pressure to compete to offer more products for less and less cost is going to be a continuing feature of our respective business lives.

The forms don't seem to vary much. We have large equity joint ventures, which seem to be in a minority and you all get to look at those in advance, or a great many of them, they have to be prenotified. Most that occur are less ambitious than that, and involve joint research, which we think is a very popular, probably the most popular form of competitive collaboration that we are aware of today. Or they can involve the sourcing, or design of a small component that will fit into a very large hole. Those are quite commonplace. And finally we have benchmarking, which is where various firms, both competitors and industries which don't compete, will sit down and examine the best practice, how you do something, compare that, take it back to your own establishment, try to improve on it, and so on. It is a continuing process; in my experience, quite beneficial to all concerned.

The effects don't seem to involve much lessening of competition in the joint ventures that we are aware of in the sense that they very rarely involve joint marketing, or joint pricing. They are much, much earlier in the development process, benchmarking, for example, and should have no effect on the pricing or marketing at all, except it may result in a better product at a reduced cost.

A tiny component of a very large hole, such as a motor vehicle, again, there will be no downstream effects from that except the product may be a little better, or a little cheaper. So we didn't see a necessary lessening of competition because people are doing things jointly, especially at the very early stages, so long as pricing and marketing are kept separate.

Indeed, there have been a great many examples in the auto industry. I started with General Motors/Toyota. That involves a joint vehicle; basically, the same vehicle, but it's differentiated in terms of its sheet metal and it is marketed and priced entirely separately. And to our surprise, all the prices came out quite differently. People weren't willing to pay as much for one as they were for the other.

We have a similar arrangement with Nissan on a van that we call the Villager, and they call Quest. They don't look quite the same and are not priced the same, and certainly are not priced jointly. Chrysler has a similar arrangement with Mitsubishi and so on.

In terms of policy questions, we were rather satisfied with the state of the law, and its clarity. We understand that per se treatment is to be imparted to naked restrictions on price and output, which we are all comfortable enough to summarily condemn.

Other things such as the rule of reason, if the participants don't have market power, that will very rarely be a serious issue.

We have all had unpleasant surprises or at least some of us have in terms of government reaction because of differences over market definition or different theories of government enforcement that arise from time to time, but in general, we find that what we do in this area is fairly predictable in terms of legality, and in terms of probable reaction by the Federal Trade Commission or the Department of Justice.

You have asked us to comment on six issues that you have looked at, whether any of those should be out of bounds. We don't think so in the appropriate case, but generally, we think the emphasis should be on what are the effects on the price and output. If the competitors have market power, or if they can get market power, then you might want to look at collateral restraints.

One that we have always been troubled by is spill-over effects. Spill-over effects occur in any situation where any competitor talks to anybody about anything, no matter how innocuous or how beneficial. We have found that internal guidelines, the threat of criminal penalties, the threat of criminal and civil litigation, good antitrust advice both inside and outside, and the fact that competitors who remain competitors really do want to learn all the morals, rather than collude, operate as natural checks on spill-over effects in most situations, which is not to say that if you have serious concerns or the evidence of spill-over effects you shouldn't investigate that.

One other thing we -- my test, when I approve a joint activity, after some years of doing it, is to tell the people involved, after we have determined what they are doing would be lawful, is to use their own best business judgment to only exchange the minimum amount of information necessary to accomplish that lawful goal.

And if they have doubts about that, they can talk to a senior manager if it is a business policy matter, or they can talk to lawyers if there is any doubt at all as to the legal propriety. That seems to work fairly well. I have actually been in joint activities where the participants were reluctant to exchange anything at all because one company or the other thought they had a real competitive advantage and they wished to maintain that. And sometimes for that reason the joint activities did not go forward.

One of the -- per se, we think per se has its place. We are not suggesting that it be abolished altogether. Again, for naked restrictions on price or output, that is probably the appropriate rule.

Most of us had no difficulty in the vast majority of situations in deciding whether the rule of reason or per se would apply. In rare situations, I was only aware of one in my entire career, an advisory opinion was sought from both the Federal Trade Commission and the Department of Justice. Another approach which is probably better, is if you really can't tell whether it is per se or rule of reason, maybe you ought to try another approach. That is something less adventurous.

In terms of application of the rule of reason, we found that it applied fairly well to the production and sale of finished goods, or services. Market definition, we have -- we have had disagreements occasionally with the FTC and Department of Justice, but generally, there are only a certain number of options available and all of them are more or less rational.

One of the problems that we have had with things like the intellectual property guidelines is where you go way back in the process and start to assume that the market share for R&D, research and development, may be identical to that in the product market. And in our experience that is rarely true.

For example, Ford has about 25 percent of motor vehicle sales. Let me assure you, we do not have anything like a 25 percent share of R&D related to motor vehicles. We would count all of our suppliers, all of the thousands of inventors who invent various things and all of our competitors and their supply base abroad, and other industries that are working on things that may have automotive applications.

We were concerned about a product market which really involves no product at all. Some research involves no product. It can simply be unsuccessful. Very small bits and pieces of automobiles are never sold separately. There is no real market for selling those thousands of tiny components that go into that.

So we think that the rule of reason is sometimes difficult to apply and should be applied with some care as you work further back into the development and research process.

Joint activity in the law, we couldn't think of a single joint activity that anyone on our subcommittee had abandoned because we were unclear about the law, or we were afraid of litigation and the government in private. We thought the National Cooperative Research and Production Act had worked quite well. We had all used it, and we thought it pretty useful.

We also looked at and discussed at some length the government guidelines. We all read them with great interest, even if in theory they have nothing to do with what we do. I think the health care guidelines are helpful even though they had nothing to do with anything that the subcommittee does directly.

Good guidelines are useful analytical tools and whenever we contemplate something, they are helpful in anticipating what the government reaction might or might not be in some cases. There have been, without mentioning any of them, bad guidelines, that either don't reflect the law or are out of date.

Sophisticated firms, if they really want to do something, and think it is very valuable, tend to ignore those.

Unsophisticated firms take them literally, and may slow procompetitive conduct. But those are rare, and in the main, the guidelines have been pretty good guidelines over time and we found them useful. The merger guidelines are by far the most used and there is no mystery why. Those are the starting point. When we come in to negotiate with you about wanting a particular merger, which may superficially involve an antitrust issue, it isn't as bad as it looks or however you want to put it, but that's where we all start, including the government.

So we give those very careful attention, but the others -- I think we pay close attention to the others as well.

One of the problems with government guidelines, especially those which involve some flexibility and interpretation, is that there is some uncertainty. Most of the time we can accurately predict how you will react. But we occasionally are surprised by a market we did not think to exist, or there is some enforcement there that will arise from time to time that we had not anticipated going in.

But in the vast majority of cases, we think the law is fairly clear, and we think it is fairly predictable in terms of its application by the FTC and the Department of Justice.

We think that is far preferable to the sort of code and polling approach where you promulgate some enormous encyclopedia of guidelines trying to take account of every factual variant which we can't possibly do, and then rigidly enforcing that. I don't think anyone contemplates that but that would, we think, slow procompetitive conduct and would lead to a lot of unnecessary litigation.

Finally, you asked about the value of advisory opinions. Somebody thinks they are valuable because they are used quite frequently, especially recently in the health care area, I have noticed.

The subcommittee members have rarely used them, including myself. We thought that in general, the amount of delay involved, the very, very narrow approval, the very cautious wording of the letters, rather like a private law firm in a way, but very, very narrow approval, and the time involved probably in most cases, didn't justify the exercise although some people disagree.

Generally, we tend to rely on our own in-house antitrust people. When in doubt, we pick up the phone and call noted partners in local law firms, and proceed with the best legal advice we can get. And we have found that that pretty generally will protect us against some sort of unanticipated government hostile reaction.

That concludes my testimony, thank you.

COMMISSIONER STEIGER: Thank you very much. Questions?

COMMISSIONER PITOFSKY: Let me start off. I'm not surprised that you don't find great uncertainty with joint research, joint production, benchmarking and so on, but what we have heard is that there is real uncertainty about joint marketing, and that it would be of some help to the industry if we could come up with some safe harbors.

There is going to be a gray area that we can never really cut into, but at least if we could isolate some safe harbors on joint marketing, perhaps on the basis of market share, perhaps on some other basis, that would be of some use.

What is your reaction to that?

MR. ROGERS: I'm sure that would be welcome. It is probably fortuitous that the members of my subcommittee simply hadn't been involved in ventures where that was seriously contemplated. There may have been antitrust reasons for that -- I wasn't privy to the General Motors/Toyota joint venture -- perhaps the fear of some sort of antitrust challenge. Guidelines might, in my industry, be very helpful. And again, I get back to our proposition. I think good guidelines that accurately reflect the law and economic thinking are extremely useful.

COMMISSIONER STEIGER: Susan.

MS. DESANTI: I had questions about the spill-over effects. And I note your comments saying it is hard to know exactly what weight to give to spill-over effects in assessing the competitive concepts of a joint venture. You don't know whether it is going to be big or small.

And in terms of your personal experience, are there particular mechanisms or rules that you put into joint venture agreements on a regular basis in order to address the problem -- the potential problem of spill-over effects and to prevent them? And if so, what are the kinds of things that you have found useful in this area?

MR. ROGERS: Now, the standard terms will always include a confidentiality agreement; that is, not to disclose that which is confidential to third parties. But that really, aside from the exclusionary issue, doesn't affect third parties at all. The antitrust concerns, as I understand it, what I will call the cartel or Adam Smith theory, is that you'll disclose too much, not too little.

Some agreements relate to that, but in most, the rule involved, or the rule applied, and I found it to be applied rather rigorously by the business people, is I will give these people what they need to advance this joint project, but I will not give them anything else because it disadvantages me from a business point of view.

I recall one particularly amusing meeting where someone developed a technology which they were ordered to disclose in the context of a joint venture we thought lawful, and they absolutely refused to do so. This was something they developed for us. It was proprietary and they were darned if they were going to show to it anybody else. I mean, that is the kind of reaction that you get.

A lot of us who do a lot of joint research, US -- the Big Three, US Car Research Joint Venture that has been up and running for quite some time, and I have seen no one spilling the beans about things other than the technologies which they were exchanging.

You also have to recognize a lot of these involve scientists, true scientists, people with Ph.D.s who are technical people. They have no marketing or pricing responsibility at all. If I had finance staff people and pricing people meeting regularly all the time, I would worry a lot. But that is not happening.

What you are getting is the true scientists and they really are trying to solve a problem and they really have no incentive at all not to solve it because someone else might and put them at a competitive disadvantage.

So that problem seems to take care of itself pretty well.

COMMISSIONER STEIGER: Yes.

MR. COHEN: You mentioned that you had experience with a number of joint ventures that have involved production collaboration, but not joint marketing.

MR. ROGERS: Uh-huh.

MR. COHEN: And we think in these contexts of the possibility that competitive problems could emerge because of monopoly profits being taken upstream, and then supra-competitive prices being charged to the parents when they acquire the goods produced, and then they can compete as much as they want downstream and you still have a competitive problem there.

Could you give me a little bit of background as to what you see as the mechanisms used for pricing, the transfer pricing of the products that are produced by the joint venture when they are then sent on to a parent?

MR. ROGERS: Yes, the normal market effect of any joint product, I will talk about motor vehicles since I know about that, in fact, were inflated, at any level you would simply be uncompetitive in the market.

I don't think I'm giving away any secrets. Many vehicles right now are produced at or below cost to be sold at all, so there is an enormous pressure to get costs down in the automobile industry, about 17 million units in excess capacity worldwide, which can very easily be transferred here and most of it is aimed here, quite frankly.

So that unless the costs are kept very low, and you really haven't got an opportunity to reflect them at any level, because if you do so, unless you have some super popular vehicle, which has not happened, I don't know what would happen if we had jointly produced the Navigator, which is our current hot product. But most of these joint ventures occur in segments that have lots of competition.

For example, there is no shortage of minivans. There is certainly no shortage of small family sedans like the GM/Toyota joint venture produces, and so on. So that the pricing pressures in the market, outside of the joint venture will ordinarily assure that the joint venture has kept its lowest cost as possible, and any attempt to inflate something at some level would probably fail.

COMMISSIONER STEIGER: Thank you very much. And Dr. Chickery J. Kasouf will finish our hearings for this afternoon. We are pleased to have you with us. The doctor is an Associate Professor in the Department of Management at Worcester Polytechnic Institute where he joined the faculty in 1990. He is also Director of Management Research at Carl Gunnard Johnson Powder Metallurgy Research Center.

His interests are diverse. They range from industrial marketing to marketing research and he is a member of the American Marketing Association, the American Powder Metallurgy Institute and the Institute for Operations Research and Management Science. Welcome again, and thank you.

DR. KASOUF: Thank you. Thank you. I can't think of a much greater contrast between Visa and the powder metallurgy parts industry in terms of visibility and the value of Visa's, certainly Peter Senge's argument, the most valuable company in the world and by his measure, certainly appropriately so.

This is about a three billion dollar industry and the last time I was here, I did bring some parts that I never did get back, so I presume there are some paperweights around the building that are, you know, cams, and some sprockets.

But this research that I'm going to talk about, I have done with a number of people, David Zenger, Ulf Gummeson, Diran Apelian, Swati Nigam and Kim George, but today, actually, I don't have a lot of new research results that are germane to this, although I do have some.

The reason that I came down when I was asked, is because the industry has changed so much over the last two years since I was down here in 1995.

Powder metallurgy parts producers were basically a classic fragmented industry. No one firm had large market shares. There was tremendous price competition, no barriers to entry. The primary customer was the auto industry, and they were in the throes of trying to simultaneously outsource some of their engineering and reduce price.

In the intervening couple of years, some things have happened that I think might make joint ventures a little bit more attractive in the industry. Except for a few research centers like ours, there has been virtually no horizontal relationships that I'm aware of; very little collaboration among competitors. And typically, it does come in research centers, centered in the university, the two or three of us that have managed to do that over the past couple of years.

But one of the things that we have noticed over the last two years is that the number of firms in the industry has shrunk. A barometer that I use is when I try to do a survey of all of the firms in the industry, and the same algorithm that I'm not going to weigh you down with. We went from about 154 to 121 identifiable competitive part producers.

Another thing that is happening is that there has been some very -- that we have had the emergence of the large firm in the industry. GKN of the United Kingdom has just taken over the largest US P/M part producer. That was a firm that was basically formed with a collection of smaller P/M houses taking over one of the largest firms in the United States industry, and then about six months later, Sinter Metal was publicly traded for GKN. The United Kingdom bought that.

The pressures that the P/M part producers are under, first of all, I have got some data in here that I won't really get back into, but there's a tremendous need to do a lot of the -- a lot more engineering. In order to succeed, the firms in the industry typically have had to demonstrate greater engineering skills. There are fewer bids going out saying here's the specs, you deal with this part.

At the same time, we are looking at some cost pressures and about 10 years ago Kempton Roll, who was president of P/M Parts Producers, predicted that we would lose about 50 percent of the North American parts industry and that is starting to happen. I don't know if we will reach that point by the year 2000 which he predicted. He said it is because of the increasing quality expectations and the pressures for globalization, which are very salient in the industry right now.

I found it curious the comment that joint ventures are fragile because I think that is quite true. I know of one joint venture in the industry that was an attempt to develop a company in South America, in Brazil, that fell apart. It was about a $70 million US company trying to buy or trying to get into a joint venture with about a $10 million Belize -- I could stand to be corrected on that -- company in Brazil. And the cultural issues and the financial considerations, it never got off the ground. And that was an attempt to serve General Motors.

The curious thing about horizontal relationships is that there has been historically very little enthusiasm for horizontal relationships. Now, I have not revisited that issue domestically in about two years.

Last year we found some interest in joint venturing for overseas markets because you are typically looking at overseas companies to do the joint venture with. One of the concerns about potentially getting into a joint venture is the loss of proprietary technology and the firms that most likely have that to lose are the firms that are already fairly sophisticated.

We did find, and it was pretty strong, that there was a strong negative relationship between size and the attractiveness of any kind of partnering. Smaller firms are more willing to partner, which is not surprising, because the larger firms have been more self-sufficient.

Now, why this is an area of concern, and again, these are very emerging issues, is that I'm beginning to sense that there might possibly be a two-tiered industry evolving here. 70 percent of the US industries go to the automotive industry. The average size -- the average percentage of a North American firm is less than 40 percent, which suggests to me that you have got the haves and the have nots in terms of auto. And the autos are the most attractive applications because of sales volume. There are some price problems there but if you can keep your furnaces running for three shifts, you have got a big auto volume that is very attractive.

But you know what we are seeing, I think, is the emergence of that, of two tiers, and I'm a little bit, you know, concerned about the capacity of the smaller firms to compete effectively. And I was not surprised to find that there was a negative relationship between size and willingness to compete.

Typically, where horizontal relationships have been found in the industry, -- had been the years of trade mission education, technical support but what really surprised me, there was some enthusiasm for benchmarking, which is really opening yourself up competitively. And I found that was a contradiction and frankly, I was not able to explain it particularly well.

In my summary comments here, first of all, I think the R&D requirements are going to increase in the industry. The people, you know, the firms currently in the industry expect that to happen. And you are competing for $3 billion in sales. That is the most recent estimate of sales in the North American P/M market.

Given that we have had through WPI three separate metal centers on campus, which we shared precompetitive technology and precompetitive R&D with, to our knowledge, no collusion, plus given the not real strong enthusiasm that I saw for horizontal relationships, I don't think that developing any policies that will facilitate or at least allow collaborative relationships is going to result in anticompetitive behavior.

This industry has a history of price cutting, and as someone said earlier, the survivors want to win. I don't remember which one of my colleagues here today said that.

In terms of the impact on universities, I think it is incumbent on the universities to have deliverables that are very clear for industry. We have had a lot of success. We have got 18 members of our consortium, but I found consistently that people are suspicious in industry of any university-based relationship because university faculty tend to have different agendas in terms of publishing and things like tenure, which we, you know, in addition to money, tend to want.

So I think that universities would be well advised to think about how they are going to deal with the deliverables and deal with the reward structure.

And again, finally, I think the relationship between size and attractiveness is especially salient. I'm wondering, is it too early to tell because this change has only been occurring within the last year, year-and-a-half, -- I don't know that we are fragmented in the industry any longer. When I started to study this industry it was a fragmented industry. I think it is consolidated beyond that. And I'm concerned about having a tier of very powerful suppliers, very powerful part producers and then secondly, you are basically dealing for table scraps that don't have the ability to engage in research and have the quality standards.

And the joint venturing may well, in strategic alliances, may well be a vehicle for them to remedy their deficiencies. And again, my testimony today really focuses more on the industries involved in the research. We don't have a whole lot of new data from the companies except for some globalization issues, but I really think that I'm struck by how much this industry has changed over the course of two years.

COMMISSIONER STEIGER: Doctor, thank you very much. In reporting on your survey of current future importance of collaborative relationships, you report that respondents were generally more comfortable developing close relationships with firms that are not other P/M part producers.

Could you amplify on that and tell me what kind of relationship that creates? Are you speaking of a vertical distributor, or what do you mean by that?

DR. KASOUF: That is a curious finding, because the reason that question is in there, is that there is some evidence -- Kodama's work that showed up in the Harvard Business Review a few years ago, argued that, you know, for breakthrough technologies, that you are looking at more different technologies that come together. And I put that argument in, even though frankly, except for dealing with them vertically, I wasn't aware that P/M part producers were doing any kind of strategic alliances with metal casters. But they seem to be more comfortable with that.

But to be honest, I'm not aware of very many. I can't name a specific example of that. Historically, in the industry supply base, the powder producers in particular, and to some extent the equipment manufacturers have been -- have done a lot of the R&D with the part producer. And what will happen often, I know of one case where a company developed a proprietary powder mix that helped them keep, you know, maintain the competitive advantage for a particular part.

And that was done with one of the powder producing companies.

I know it is not unusual when a furnace is bought, or excuse me, when a press is bought for a particular part that the engineers from the press company will come in to help them work the bugs out.

So those kinds of relationships do happen in the industry. They are very comfortable with that.

In terms of, you know, to throw out the names of two companies at random, do Pressmit and Windfall have an alliance other than coming to our place three times a year to talk about our research results; I don't see that.

MS. DESANTI: I just want to ask a follow-up question on proprietary technologies and methods for protecting proprietary technologies when there is collaboration going on. The university model I think you talked about that the last time.

DR. KASOUF: Is precompetitive.

MS. DESANTI: -- is one. Are there others that are available?

DR. KASOUF: It is a question of what firms feel comfortable -- I'm not aware of -- perhaps the economists can help me here. I'm not aware of the model that is, you know, someone will say here exactly how much we are going to share. It is a question of how are you going to use the technology to your advantage, and how much are you willing to put at risk.

I have known people in the industry who have told me that, you know, we are not too concerned about losing technology because we are more concerned about developing future technology. So if somebody in the line can copy it well, that's life. We are moving on to the next generation anyway.

Unfortunately, there aren't that many firms in the industry. I can think of probably four or five who can operate like that on a consistent basis, and I think the rest are $50 million shots trying to do jobs for a competitive price and salesmanship.

COMMISSIONER STEIGER: Yes.

MS. DESANTI: I was wondering if we could go back to David Evans for a moment. I actually now have had a chance to think some more about your presentation. And I did, while we have you here, want to ask you one question.

DR. EVANS: Sure.

MS. DESANTI: We certainly do appreciate that you came to give us all of this food for thought as Commission Steiger pointed out. My question is this: You articulated a distinction between two types of rules, organizational rules, and structural rules.

DR. EVANS: Operational rules and structural rules.

MS. DESANTI: Right. Is the distinction that you are making there analogous to the distinction Mr. Allen was making about operations within the joint -- as to how individual joint venture members can compete within the joint venture, within a market on an individual basis, as opposed to rules about, or restraints that operate at the level of how the joint venture competes with other joint ventures, and with other single firm entities, or is your distinction something else?

DR. EVANS: I wouldn't want to say that they are exactly the same, but I think the inside-outside distinction that Paul was using is pretty much very similar to the structural versus operational distinction that I was making.

MS. DESANTI: Thank you.

COMMISSIONER STEIGER: And I believe Bill Cohen has a question for you if you can put up with us.

MR. COHEN: Yes. You alluded to the great number of articles that have been written on the exclusivity, exclusion issues in the credit card context. One of them I know has been developed by Professor Hovenkamp.

DR. EVANS: Yes.

MR. COHEN: And I think he suggested that there are some differences between joint ventures and individual firms in that the individual firm can be expected always to undertake whatever opportunities are available that will benefit the firm as a whole. Whereas, a joint venture might pass up on opportunities, particularly for admitting new members, even though it would benefit the venture as a whole, if it would detract from the returns to the incumbent members of the venture. I would like you to comment on that theory.

DR. EVANS: Yes, I guess I really don't know what that means to say that it detracts in the terms of the encumbered members, but benefits the joint venture. It basically says it benefits the joint venture in some sort of out-of-body sense including people who don't currently belong to the joint venture. So that doesn't strike me as making much sense.

And furthermore, I think it is actually important from the standpoint of encouraging the formation of joint ventures to begin with, to ensure that the incumbents in the joint venture do get an adequate rate of return. So the fact that one of the reasons the incumbent members of the joint venture don't want to admit a new member is that that is going to reduce their rate of return.

I think that that is, in those circumstances, a perfectly fine explanation for not admitting that new member. Joint ventures, just like single firms, ought to be able to get -- ought to be able to get a rate of return, and in addition, one can imagine that there are circumstances where it is perfectly fine for joint ventures, just like single firms, to get ex-post supra-competitive rates of return. Again, ex-post.

COMMISSIONER STEIGER: Well, on behalf of the Commission we want to thank all of our speakers.

MR. TOM: Sorry, as long as we are all picking on you. Commissioner Steiger had asked a question that I wanted to ask, but let me see if I can get at it slightly differently. You mentioned Joel Klein's approach.

DR. EVANS: Yes.

MR. TOM: If you could help me distinguish between your approach for operational rules, and what you see as Joel Klein's approach, that would be very helpful to my understanding.

DR. EVANS: Sure, my understanding of Mr. Klein's approach is that it would be incumbent upon the joint venture to establish the efficiency justification for whatever rule, operational rule, for example, it has adopted. And that is the first thing that would need to be done. Before we get into any kind of inquest concerning market policy, the burden of proof, as I understand it in his framework, to treat the joint venture as a combination of competitors, would be on the joint venture to establish the reporting efficiency methods of the rule.

The approach that I suggested today, would start out initially with the market power screen, which would say first of all, is there any evidence that the rule that we are looking at is harmful to consumers? If there is no evidence that the rule that we are looking at is harmful to consumers, I would stop at that point and not do any further inquiry concerning efficiency notice.

And that is a particular reporting approach when one thinks about the Dean Witter case where I would argue if you take a look at the actual record in that case, as opposed to some of the statements, if you look at the actual record in the Dean Witter case, there simply wasn't a showing of consumer harm.

And I would make the same point with respect to the NaBanco case, that even though it might be possible to come up with a theory of competitive harm in both of those cases, if in fact, you look at the record, there wasn't a whole lot of evidence put forward concerning consumer harm, and therefore, I think both of those cases could be readily disposed of using the market power screen, properly employed.

MR. TOM: Thank you. That is very helpful, but as usual, you give a good answer and you raise more questions. Your reference to the Dean Witter case makes me wonder if I'm able to understand the distinction between operational and structural rules. I had understood your three-part test as applying to operational rules, and I thought the Dean Witter case was a question of exclusion of membership, and therefore, a structural kind of issue.

Did you mean to apply the same kind of test to the Dean Witter situation, or what?

DR. EVANS: Well, yes, and no. And I think this isn't entirely clear in the framework. I think that Dean Witter could be disposed of in two ways.

First of all, it can be disposed of under the first screen, which is no evidence of consumer harm.

But in addition, I think it can be disposed of also in a safe harbor that I think flows out of the rule of reason analysis, as applied to structural rules, which in this particular case, is that, for a variety of reasons, there is no reason why you would make a joint venture, unlike a single firm, admit a competitor to the organization.

MR. TOM: Okay, thank you very much.

COMMISSIONER STEIGER: Well, on behalf of the panelists, sincere thanks for the very informative presentations this afternoon on our very important issues, and especially since you have all done this for us before.

And we are grateful to you coming out for what we think is a rather important issue. Thank you all.

(Whereupon, the hearing was concluded at 3:17 p.m.)

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C E R T I F I C A T E   O F   R E P O R T E R

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CASE TITLE: Joint Ventures Project

HEARING DATE: Tuesday, June 24, 1997

I HEREBY CERTIFY that the transcript contained herein is a full and accurate transcript of the notes taken by me at the hearing on the above caused before the Federal Trade Commission to the best of my knowledge and belief.

DATED:

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Karen N. McConnell, CSR-RPR-RMR

C E R T I F I C A T I O N   O F   P R O O F R E A D E R

I HEREBY CERTIFY that I proofread the transcript for accuracy in spelling, hyphenation, punctuation and format.

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SARA J. VANCE