Basic Allegations: MC1 Case Study

In 2016, the legislature passed a stimulus package that contained a "Buy Domestic" provision. It made available billions of dollars of government funds to stimulate the economy with construction projects, including water infrastructure. Municipalities had to use domestically made materials on water infrastructure projects to be eligible for these government funds. Some municipalities already had "buy domestic" policies of their own, and some contractors had a strong preference for them. So there always was some need for some domestic manufacture. The availability of stimulus funds for projects using domestically manufactured pipe fittings increased demand tremendously. In June 2016, ST2, a seller of imported iron pipe fittings, decided that it would begin to make them domestically so that it could compete for waterworks projects funded by the stimulus project. MC1, as the only domestic producer of iron fittings, was worried about losing market share and about price competition from ST2.

Pictures of typical fittings:

Dominance in the Relevant Market: Supply of Domestic Ductile Iron Pipe Fittings
The closest substitute is made from polyvinyl chloride (PVC) and lacks the strength of iron for high pressure applications. Foreign produced pipefittings are not reasonably interchangeable for projects specifying made in domestic-only fittings because of legal requirements or end-user preferences. Even prior to 2016, MC1, the only firm making fittings domestically was able to charge 20-50% premium for the same fittings when sold to a buyer that specified it had to have fittings made domestically without fear of those buyers switching to imports. MC1's own business documents and practices recognized separate markets for domestic and non-domestic fittings.

MC1 admitted its share had consistently been above 90% for domestic fittings. Production costs were identical for fittings made domestically whether sold to someone with or without the option of imported fitting, but MC1's margins when selling to those who are required to use domestically manufactured pipe fittings were significantly higher. In response to the increased demand for domestic fittings, MC1 implemented some price increases even after ST2 entered the market for domestic fittings.

It costs millions of dollars to build or convert a foundry and 3-5 years to enter. ST2 in 2016 contracted with iron foundries in the jurisdiction to make only some types of fittings. About 80% of demand could be met with 100 or fewer commonly used sizes and configurations.
But, distributors needed access to the full-line, and MC1 was the only full-line supplier of domestic fittings.

MC1's 2016 New Full-line or No-Line Policy

MC1 required distributors to purchase a "full-line or no line" of domestic fittings from MC1. Most distributors interpreted the policy to mean that MC1 would terminate their ability to purchase any of MC1's domestic fittings if they purchased any domestic fittings from another supplier. MC1 said it viewed distributors as "critical to [its] success" and made 99% of its fittings sales through distributors. ST2 also viewed the distributors as critical to success. Benefits that distributors provide include: better sales coverage, local influence and knowledge of projects in their market area, carry local inventory, aggregate small orders and shipments for scale efficiencies, carry credit risks. Access to these independent distributors was essential to both MC1 and ST2, but with the new MC1 policy access was seriously curtailed.

Impact of MC1's Policy
Access to Distribution: ST2 and other potential entrants claimed they could not access some important distributors. The two largest distributors followed a policy of purchasing domestic fittings only from MC1 and from ST2 only under a few exceptional circumstances: Distributor 1 (35% share of distribution) – Distributor 2 (25% share of distribution). Prior to MC1's new policy Distributor 1 had purchased from ST2, but cancelled its pending orders when MC1 announced the new policy. Distributor 3, the third largest distributor, listed ST2's vendor status as "Not Approved."

After MC1 announced its policy ST2 lost requests for price quotes. By limiting ST2's sales, ST2 claimed that the Full-line or No-line Policy made it uneconomical for ST2 to invest in its business and reach a scale of efficiency sufficient to be a competitor that could constrain MC1's prices. To do so, ST2 needed its own production facility. ST2 had even gone so far as to identify a specific foundry; begin negotiations to buy it; and calculate how much in sales it needed to buy it. But, its limited sales prevented it from purchasing the foundry needed to reduce its production costs and produce a full-line of domestic fittings. So, instead of acquiring its own foundry, ST2 contracted with six foundries to produce raw castings that ST2 shipped to its domestic facility for finishing. This method of production was more costly with less specialized and efficient equipment and smaller batches. As a result, ST2's partial entry did not bring prices down during the three year time-period for which we know prices.

Prices Maintained At Monopoly Levels: MC1's financials showed that while production costs remained flat, gross profits increased. MC1 actually raised prices even after ST2 had entered. MC1's documents showed that it thought that if ST2 entered, prices in the domestic market would likely fall. The document showed that MC1 thought it would have to lower prices to keep its near 100% share if ST2 entered.

MC1's Defense

MC1 argued that the program was short-term and voluntary. ST2 was actually able to enter and gain a small share of market. The Full-Line or No-Line Policy was not the ***cause*** of ST2's limited sales or the elevated prices. It was ST2's inability or unwillingness to jump into the market feet first and take the risk of making the investment needed to be an efficient producer and competitor.

No Substantial Foreclosure: Whatever foreclosure from distributors that the policy caused was not ***substantial***. There was no evidence that the policy was responsible for price behavior. An unexpected government policy delivered a monopoly to MC1. It was an historical accident for which MC1 should not be punished. MC1 argued that its policy did not significantly foreclose ST2 as evidenced by the fact that ST2 was able to sell to many different distributors. It is undisputed that, for example, in 2016 twenty ST2 customers increased purchases and that ST2 sold $6.5 million in domestic fittings in 2017 and 2018. ST2's entry was limited more by some distributors' doubts about the quality of ST2's supply of domestic fittings and its inability to meet demands in a timely fashion. Prior to MC1's Policy and 2016 "Buy Domestic" provision, ST2 had 20% of the overall fittings market. In less than three years from 2016, it went from 0% market share to 10% of domestic fittings. So, even at its best, ST2 might have been able to have its share of domestic fittings match its overall share.

No Effect on Prices: Prices remained elevated only because ST2 wanted to share in these elevated monopoly prices.

Offsetting Efficiencies Passed On To Consumers: MC1 argued that it needed virtual exclusive dealing to preserve a sufficient volume of sales to keep its domestic foundry afloat, the last domestic foundry. MC1 also argued that the policy prevented customers from "cherry-picking" the highest selling items from ST2 and other non-full-line rivals. MC1 argued "cherry-picking" would lead to its collapse as a full-line seller, something that many distributors valued highly.

Questions for Round 1

1. Was there exclusion? If so, by what mechanisms did MC1 achieve it? Does it matter that MC1's program did not require distributors to commit to purchasing MC1's fittings exclusively for a lengthy period of time?
2. Was ST2 successful in entering the domestic fittings market? What criteria would you use in deciding if entry was "successful"? Was three years between early 2016 and late 2018 enough time to answer that question? How does Star's entry impact a finding of dominance and a foreclosure analysis?
3. ST2 decided it could not buy and operate its own domestic foundry because it would not have enough sales. Is this fact enough to prove a substantial lessening of competition? If not, what else would you require?
4. Was the harm, if any, from a purely exclusionary MC1 policy or result of legitimate hard-nosed competitor-to-competitor competition?
5. Did MC1 gain power to raise prices or maintain power? Did customers have other options?
6. Did MC1's policy harm competition?

Questions for Round II

1. Do you think that MC1 had legitimate business reasons that were not purely exclusionary for its Full-Line program? What more would you want to know?
2. Could MC1 have achieved these business goals in a less exclusionary way? Must MC1 show that its Full-line program was the least exclusionary means of achieving its business purpose?
3. Did the business reasons justify the Full-Line program and its effect of making ST2's entry more difficult?