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THE AUSTRALIAN MERGER GUIDELINES

Last year, Australia amended § 50 of the Trade Practices Act to tighten the test for mergers. Under the new test, a merger would breach § 50 if it would have, or be likely to have, the effect of "substantially lessening competition" (instead of creating or enhancing a position of "dominance" as under the old test) in a substantial market. The amendments allow the Commission, and the Trade Practices Tribunal on appeal, to authorize a merger where it can be established that there is sufficient public benefit (such as efficiency gains from economies of scale and scope). The new test was accompanied by a non-exhaustive list of "merger factors" which must be taken into account in evaluating the competitive effect of a merger. In addition, the Trade Practices Commission was instructed to issue merger guidelines for evaluating mergers incorporating those factors.

The guidelines, which were issued in November 1992, begin the evaluation process with market definition. They adopt the North American analytical framework in which the market is defined as an area (in both product and geographical space) over which a hypothetical monopolist, not subject to the threat of entry, could profitably impose a "small but significant and non-transitory increase in price," usually defined as 5-10 percent, above the competitive price.

The second stage is the calculation of market shares and concentration ratios. The approach taken in the guidelines comprises two tests. The first reflects concerns about the exercise of unilateral market power by a single firm within a market. Where a merger would result in the merged firm supplying 40 percent or more of the market, the Commission will require further market analysis. The second test reflects concern with the coordinated exercise of market power. If a merger would result in the four largest firms supplying 75 percent or more of the market, the Commission will conduct a full market analysis. However, if the merged firm would not have market share exceeding 15 percent, the merger will not raise concerns despite the 75 percent concentration ratio.

If the evaluation of market shares and concentration raises concerns, import competition is considered. In some instances, the market share of imports may understate their competitive impact. Supply may be infinitely elastic at a world market price plus transportation costs and tariffs, placing a cap on domestic prices. This is particularly likely in markets for homogeneous goods not subject to import quotas. In these markets, it may be relatively straightforward to establish the presence of effective competition. If this can be done, there will be no need for a detailed evaluation of barriers to entry. Otherwise, the guidelines call for an evaluation of entry conditions which is done by considering evidence that effective entry is likely to occur. Effective entry is defined as that which would occur within a two-year period if the merged firm were to exercise market power and which would be on a sufficient scale and sufficiently attractive to consumers to effectively restrain such conduct.

Finally, if neither import competition nor entry conditions are sufficient to prevent a substantial lessening of competition, any other relevant factor must be considered. Particularly important is the consideration of any countervailing power issues; a merger may be procompetitive if it creates countervailing power against either suppliers to the firms or buyers of the firms' output. Other factors also include whether a merger would result in the removal of a vigorous and effective competitor. If so, it would tend to increase the likelihood that the merger would substantially lessen competition. However, if the merger is between two weaker firms, it may create a more effective competitor. Other factors include the past conduct of

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firms and whether market conditions are conducive to coordinated behavior.

Though the guidelines have been criticized as being too general, overly detailed guidelines would not be appropriate under a brand new governing statute. Experience with the statute and guidelines will likely guide the development of the guidelines to suit the particular needs and desires of Australia.

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MARKET RATES FOR NATURAL GAS TRANSPORTATION

Natural gas pipelines are beginning to take advantage of the opportunity to escape rate regulation by the Federal Energy Regulatory Commission (FERC). In two current cases (Natural Gas Pipeline of America and Transwestern Pipeline), pipelines have petitioned to charge market rates for some transportation services on the grounds that no one offering these services has any significant market power. In both cases, the pipelines structured their proposals so that only a relatively simple market analysis is necessary to show the lack of market power.

FERC's evaluation of the pipelines' proposals substantially parallels merger analysis conducted by the antitrust agencies, but there is an important difference. A typical antitrust review involves a comparison of market outcomes with and without the merger. FERC can similarly compare the market outcomes where it either accepts or rejects unregulated market rates, but it may also consider market rates conditioned upon less costly non-rate regulation.

The pipelines have proposed that transporters offering short-term transportation on the pipelines—either long-term contract holders reselling their transportation rights or the pipelines themselves—be allowed to charge market rates. FERC would lightly regulate these transporters by enforcing two rights granted in the proposals. The proposals would allow shippers that hold transportation rights to resell them, thereby increasing competition by allowing shippers to become transporters. They would also allow shippers to change designated receipt and delivery points within relatively large, specified zones at no cost. With these two rights, it is relatively easy to show that the transporters offering short-term transportation on these pipelines have no significant market power.

The proposals simplify market power analysis in two ways. First, the rights granted shipper/transporters create relevant geographic markets that are at least as large as the zones that the proposing pipeline specified for free changes of receipt or delivery points. The resulting geographic markets are larger and fewer in number than they would be without the proposals.

The second simplification is that market power is an issue only when the efficient price in a relevant market is above a cost-of-service rate. This is true because the proposals do not change the regulation of transporters that do not use the proposing pipeline's capacity (even if they serve the same market) and because FERC already allows discounting from cost-of-service rates. In this situation, rivals whose regulation remains unchanged could not adjust their prices in response to a hypothetical price increase. Thus, only those transporters that charge market rates by virtue of using capacity on the proposing pipeline would be included in a market concentration analysis. The market concentration analysis is then based on estimating, in each zone, the capacity that a transporter could offer to the market using capacity on the proposing pipeline. Analyzing market power is simpler because pipelines keep this information themselves on a routine basis.

Market rates may be justified with other approaches as well. Market rates for short-term transportation may be justified if a pipeline adopts a particular computer-assisted auction. Such an auction establishes a low-cost spot market for trading rights to natural gas and pipeline transportation, including resold transportation rights. Its primary benefit is in dramatically lowering transactions costs for traders in the spot market, but it also prevents the exercise of market power, and can be used to justify market rates in spot trading. Also, market rates for long-term, as well as short-term, transportation rights may be justified if this transportation is between two market hubs that are shown to be competitive.

Pipelines can pursue profitable opportunities created by recent regulatory changes to use market rates for short-term transportation. Profitable opportunities may also arise from the adoption of market rates for some long-term transportation. In addition, as

FERC gets more experience with market rates, it may initiate a reduction in regulation in competitive markets, and possibly create even more competition itself.

Senior Economist Dan Alger testified before FERC for Natural Gas Pipeline of America and Transwestern Pipeline. He has previously worked with FERC and FTC.

RATE REGULATION COMES TO CABLE

The Cable Television Consumer Protection and Competition Act of 1992 requires the Federal Communication Commission (FCC), in conjunction with local franchising authorities, to regulate rates on basic and extended basic cable service and on the equipment used to receive those services. Some rates, such as those for premium services that are sold on a per channel or per program basis and those charged by the few systems deemed subject to effective competition, are not regulated. Cable regulation has generated considerable controversy, both in principle and because of several provisions in the current rules.

The FCC developed benchmark rate regulation as the primary method for regulating cable rates. A system's benchmark rates for basic and extended basic service depend on its numbers of channels, satellite channels, and subscribers. Benchmark rates for equipment rental and installation depend on the costs of providing or installing the equipment. The FCC requires regulated systems to reduce rates to the benchmark level or by 10 percent, whichever reduction is less. In addition, systems must rescind any rate increases taken since September 1992 that exceed the rate of inflation.

The current rules allow cable rates to increase by the rate of inflation and in response to increases in certain costs. The FCC is considering limiting cable rate increases to take account of the hypothetical growth of industry productivity. Such a limitation is unwarranted. Among other reasons, progress in this industry has consisted in large part of improving the quality of programming and service, but such improvements tend to increase costs. Limitations on rate increases might discourage such improvements.

The FCC's rules allow cable systems to charge rates above benchmark levels if the systems can justify those rates based on the cost of service. This provision may be motivated by the constitutional requirement that systems be allowed to earn a fair return on their investment. While systems have the right to choose either benchmark or cost of service rates, the FCC hopes most systems will choose the benchmark system. The FCC believes that the benchmark system is easier to administer and allows greater incentives to efficiency than cost of service regulation.

Few cable systems are likely to file for cost of service rates, however, if the FCC adopts a proposal to measure the rate base using original cost. The original cost method usually underestimates the true value of a firm's assets because it ignores increases in asset prices and because it excludes intangible assets. A more accurate method of measuring the rate base is competitive market value, the market value of a system that is charging competitive rates. One recent study found that the competitive market value of cable systems is over 3.5 times their original cost. The cable industry is unlikely to be able to earn an adequate return on investment if it charges cost of service rates calculated using an original cost rate base.

While benchmark regulation will reduce rates on average, it will also change the structure of rates in ways that will lead to increases for some subscribers. For example, the FCC made the benchmarks "tier neutral," which means that the rate per channel is the same for every regulated tier of service. The FCC adopted tier neutrality to simplify administration and to avoid creating incentives for operators to reduce the programs on the basic tier. Some systems, however, had lower rates per channel for the basic tier than for other tiers, and they responded to tier neutrality by increasing the basic rates. Not only have the new constraints on rate structure hurt some subscribers, they have also complicated operators' already difficult task of pricing a large number of service and equipment options.

The cable industry has many characteristics that make it particularly difficult to regulate. The industry consists of a large number of firms selling highly differentiated products whose quality is subjective and hard to measure. Furthermore, the industry's products and technology are constantly changing. Determining the benchmark rates for specific services and equipment is complex; conducting a cost of service filing is even more difficult. Nevertheless, that is the reality of the new regulatory environment in the cable industry.

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MISUNDERSTANDING THE ROLE OF COMPETITION IN CONTROLLING HEALTH CARE EXPENDITURES

One of the principal goals of President Clinton's proposal for health care reform is to reduce rapidly increasing health care expenditures. The proposal depends heavily on competition within a system of regional health purchasing alliances through which most health insurance would be purchased. The large number of consumers covered by the alliances is intended to produce bargaining leverage against health plans. In principle, health plans would compete to be selected by alliances by offering lower prices and the most desired providers. However, the President's actual proposal forgoes competition and largely requires the alliances to offer a contract to every qualified health plan. Consequently, the success of the proposal depends on the existence of vigorous competition among health plans to be selected by the insured. If such competition exists, however, it is unclear why government intervention is needed to achieve these results.

The existence of competition among providers and health plans is not enough to produce a desirable result because the alliances themselves will face little or no competition. All employers will be required to purchase insurance for their employees, and all but the largest must get it exclusively through their regional alliance. This structure will leave the alliances with little incentive to reflect consumer preference when choosing among different health plans. In a free market, competition forces providers and managed care plans to be efficient. Those suppliers that fail to meet the market's standard are ultimately compelled to leave the market. By contrast, there is no apparent mechanism by which an inefficient alliance would be forced to exit. Unless the threat of exit is real, even the most poorly run alliance may have little incentive to improve its performance.

While regulating price is not their stated purpose, the alliances' assured demand, incentive structure, and protection from exit suggest that they will function like other price-regulating government bodies. If the alliances are to serve their stated function they must, like a regulatory body, determine what prices offered by health care plans are acceptable. Not having the alliances make this determination would acknowledge that competition among plans, which is the hallmark of the currently evolving managed care system, is sufficient to produce an acceptable result.

Even if the alliances had the proper incentives, they ultimately fail to address the principal cause of large and growing health care expenditures. Several sources have identified technological change and an increase in the intensity of care as the most important factors accounting for growth in healthcare spending. Other findings point to the symbiotic relationship between technology and traditional cost-based insurance driving up both the costs of care and the demand for insurance. Cost-based insurance provides an incentive to introduce any new technology that improves the quality of care, no matter how small the improvement and no matter how high the cost. While managed care plans have been able to lower the costs facing their enrollees, these have been one-time-only savings. Because they use the same expanding technology, the plans' costs have risen at about the same rate as overall healthcare expenditures.

The traditional use of cost-based insurance stems in large part from the failure to tax most employer-provided health benefits as income. This discount (roughly 50 percent) encourages employers to offer higher-cost, more comprehensive plans. Eliminating the tax break for employer-financed health benefits, at least on benefits above some minimal acceptable level, would reduce the demand for cost-based insurance, which in turn would moderate incentives to introduce high-cost technologies.

The causes and the possible policy responses to the large and increasing levels of health-care expenditures are many. Successfully addressing these issues requires the Administration to identify the causes and to propose policies to rectify specific problems. A policy based on managed competition and short-term price controls fails on both counts.

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