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John R. Morris reviews the reliability of price indices for natural gas published by private entities in the context of FERC's electric generation refund cases in California. An economic review of the indices undermines FERC's contention of their unreliability. The review considers the routine use of certain indices in California by both sellers and buyers as well as high correlations of the indices with each other and with actual transaction prices.

### Managed Care in Hospital Merger Analyses

David A. Argue considers the role that managed care plans continue to have in ensuring competition among hospitals, even in an environment of more inclusive hospital networks. Managed care has historically influenced patients' hospital choice by limiting the number of hospitals in their networks. Other tools available to influence patient choice include point-of-service plans, fully capitated products, variable premiums, tiered networks, and consumer-driven plans.

### Recent Court Judgments and EC Merger Control Policy

Andrea Lofaro, a partner at EI's European affiliate, RBB Economics, discusses three recent judgments by the European Court of First Instance annulling recent EC Commission merger decisions. The Court confirmed the prerogative of the Commission to examine collective dominance, leverage and tying concerns. It has made clear, however, that the Commission must clearly articulate its theory of competitive harm and test that theory against the facts.


# Evaluating Private Price Indices

By John R. Morris

In August 2002, staff of the Federal Energy Regulatory Commission (FERC) questioned the reliability of privately published California natural gas prices. In FERC's electric generation refund cases for California, FERC staff proposed to use published producing-basin prices plus a transportation charge to California. Allegations about the quality or reliability of price indices have arisen previously in private litigation and other government investigations and are likely to arise again. A sound methodology for evaluating these allegations can be found in the application of economic principles. Among the approaches that can assess the reliability of private price indices are the use of these price indices by market participants, correlations among prices, and comparisons of actual transactions with price indices.

The price indices at issue are average price and mid-point prices found in surveys of actual transactions typically performed by industry publications. Depending upon industry practice and the quality of the indices, these price indices can be used for setting contract prices. For example, the price in a long-term gas purchase contract might be written to adjust with the *Natural Gas Intelligence (NGI)* Monthly Index. Such pricing terms ensure both the buyer and seller that they are receiving equitable prices–as long as the index price reliably measures changes in market prices.

The use of price indices by market participants reveals information about the indices' reliability. The widespread use by both buyers and sellers of some indices more often than others suggests that market participants have confidence in those indices they use. It is unlikely that both buyers and sellers would prefer to rely on an index biased in the same direction. Therefore, commonly used indices, such as the daily and monthly indices published in *Gas Daily* and *NGI*, should be presumed to be reliable indicators of changes in market prices.

The correlation of prices at one location with prices at another location also provides information about the reliability of price indices. Prices should increase or decrease together (or, in terms of statistics, prices should be highly correlated) if there are no impediments to the movement of supplies from one location to another. If, however, the movement of supplies is known to be impeded by factors such as constrained pipeline facilities, then prices will not necessarily be correlated. The correlation would break down because one of the economic forces that cause prices to move together–shifting supplies-would be insufficient.

The correlation of prices among price surveys provides another check on the reliability of the surveys. If alternative surveys report similar prices, then the surveys are more likely

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# Continued Role for Managed Care in Hospital Merger Analyses

By David A. Argue

Throughout much of the 1990s, managed care played a significant role in the analysis of competition related to hospital mergers. Managed care plans' ability to control patient volume gave them considerable leverage over hospitals in contract negotiations. In the past several years, however, consumers in many areas of the country have demanded more inclusive networks of hospital providers. This trend appeared to undermine one of managed care plans' most effective means of ensuring competition among hospitals–the ability to exclude hospitals from managed care networks and thereby deny them patient volume. However, managed care plans have always had the incentive to promote hospital competition. They have many tools to influence patient choice and have recently developed additional means.

Historically, one of the more effective means by which managed care plans induced competition among hospitals was by limiting the number of hospitals allowed to provide services to the plans' enrollees. Managed care plans were constrained by a need to contract with enough hospitals to provide sufficient access for their enrollees, but beyond that constraint, they could exclude hospitals that failed to offer sufficiently attractive rates. As a result, hospitals competed vigorously for access to managed care enrollees to help fill their capacity. Over time, however, consumers began to demand more inclusive networks of hospitals, perhaps, ironically, in response to plans' success in controlling healthcare costs and thus controlling premium growth. In response to that demand, the ability of managed care plans to construct attractive hospitals networks that excluded specific hospitals declined appreciably.

A seemingly logical conclusion to draw from the trend toward inclusive networks is that managed care plans have lost their negotiating clout. Without the ability to exclude hospitals from their networks, managed care plans might be seen as being virtually powerless to enforce competition among hospitals. In turn, the antitrust agencies might not place much significance on managed care's role in hospital merger reviews if plans cannot induce competition among hospitals. As was alluded to by the 8th Circuit in *FTC v. Tenet Healthcare*, however, managed care plans have always had incentives to maximize their profits by reducing their expenditures for hospital services. Several means by which managed care plans can induce hospital competition (i.e., influencing patients' choice) continue to exist despite the predominance of highly inclusive networks.

Among the tools that have always been available to managed care plans are point-of-service (POS) plans, which are essentially combination HMO/PPO plans. POS plans allow patients to choose less restrictive networks at a higher cost to themselves. If a patient chooses a provider in the more restrictive HMO network, he or she typically is fully covered. If the patient chooses an out-of-network provider, the amount of the co-pay or deductible typically increases. Another type of managed care product that has been in existence for many years are fully capitated products. These products pay primary care physicians a fixed fee per member per month regardless of the services the enrollee uses. Consequently, to the extent the physician can influence the enrollee's hospital choice, the physician has an incentive to direct the patient to the most cost-effective hospitals. A third method for providing enrollees with incentives to choose less costly hospitals involves variable premiums. Variable premiums enable employers to pass on to employees the higher cost of using more expensive hospitals through a surcharge or higher contribution by the employee. The existence of variable premiums was a factor in the 8th Circuit's decision in *FTC v. Tenet Healthcare*. More recently, managed care plans have taken a page from the pharmacy benefits management playbook with the advent of tiered networks. Pharmaceuticals have long been divided into different tiers with varying out-of-pocket expenses. Tiered hospital networks work in much the same way by using differential co-pays, deductibles, or co-insurance to impose on the patient the cost of choosing a more expensive hospital. Finally, among the most recent innovations in managed care are consumer-driven plans that provide consumers incentives to choose cost-effective healthcare by giving them a fixed amount to spend however they wish. Expenditures beyond the fixed amount (up to a limit) are covered by the patient, and unspent funds are rolled over to the next year.

No doubt exists that managed care plans strive to minimize health care costs. It is clear that they have several mechanisms to reach that goal. Thus it is premature to consider managed care plans to be irrelevant to hospital merger analysis. Rather than returning to a world of indemnity-like insurance that makes no attempt to control hospital costs, managed care plans have pursued their profit-maximizing objectives and developed new means of controlling costs.

*Corporate Vice President David A. Argue has extensive experience in health care matters including hospital merger analyses both before the antitrust agencies and in the context of private litigation. He worked on the economic analysis in* FTC v. Tenet Healthcare.

# Recent Court Judgments and the Future of European Community Merger Control Policy

By Andrea Lofaro, RBB Economics

The year 2002 has been a dramatic one for European Community (EC) merger control. The European Court of First Instance (CFI) has for the first time annulled merger decisions taken by the EC Commission in *Airtours/First Choice, Schneider/Legrand* and *Tetra Laval/Sidel*. The judgments of the CFI have cofirmed criticisms of the rigour of the current EC Commission's merger analysis and have prompted proposals for a series of reforms to the current regime.

> These judgments make it clear that the Commission must articulate its theory of anti-competitive effects and test it with industry facts.

In *Airtours/First Choice*, the Commission had blocked the proposed transaction due to cocerns about co-ordinated effects ("collective dominance" in EC parlance) between the three largest suppliers of short-haul package holidays in the United Kingdom. The Commission had alleged that collective dominance would arise not in the setting of prices–since products were recognised as being highly differentiated–but in the setting of capacity. While accepting that this "semi-collusive" mechanism could work in theory, the CFI dismissed it mainly on the grounds that the Commission had not established that such co-ordination was likely.

In *Schneider/Legrand*, the CFI rejected the Commission's theory of anti-competitive effect based to a large extent on the assumption that the post-merger entity would have benefited from its ability to supply an unrivalled range of electrical equipment at the expense of smaller and more specialised competitors. Specifically, the CFI found that the fact that Schneider holds large shares in post-terminal wiring accessories markets in Nordic countries, and that Legrand is more established in southern Europe, does not permit the inference that the product offerings of the Schneider-Legrand group would have given the new entity an unacceptable advantage over its rivals. Moreover, even though the CFI confirmed that the merger would have given rise to serious competition cocerns in France (where a large horizontal overlap existed), this part of the decision was also annulled due to a procedural error made by the Commission.

In *Tetra-Laval/Sidel*, the Commission blocked the merger despite the lack of any significant horizontal overlaps on the grounds that bundling and other post-merger practices would have resulted in the leveraging of market power from the carton packaging market, in which Tetra holds a dominant position, to the PET packaging market, where Sidel is the leading provider of equipment used to make PET bottles. Again, the Court upheld the principle that conglomerate mergers can give rise to genuine competition concerns. However, it found that in this particular case, the Commission had not provided sufficiently convincing evidence of the potential leveraging methods which would enable the merged entity to acquire a dominant position in the PET market.

These Court judgments have confirmed that the Commission is entitled to examine collective dominance concerns as well as leverage and tying effects arising from conglomerate mergers. This is fully consistent with the recent economic literature which has shown that these concerns cannot be dismissed *a priori*. Therefore, firms contemplating a

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## Affiliation of Economists Incorporated and RBB Economics

Economists Incorporated is pleased to announce its affiliation with RBB Economics, one of Europe's leading competition consulting firms with offices in London and Brussels. RBB provides expert economic advice on all aspects of the application of European Community and national competition law. RBB principals have provided advice on more than 50 Phase II merger cases and numerous Article 81 and 82 investigations. They have also represented numerous clients before national competition authorities and national courts, including those in Germany, the Netherlands, the United Kingdom, Italy and Belgium.

Like Economists Incorporated, RBB often assists in the assessment of regulatory risk and the preparation of initial notifications to competition authorities. Included in these tasks are identifying and analyzing key competition issues. As part of this effort, RBB often prepares independent economic reports and analyses and presents them to European antitrust authorities. In addition, RBB frequently assists and participates in meetings with the competition authorities.

Over the years, EI and RBB economists have participated in some of the largest multi-national antitrust matters including the Mobil/Exxon, Alcoa/Reynolds, and Ciba Geigy/Sandoz merger investigations. Through our affiliation, we hope to draw on each other's experiences, providing our multinational clients with a comprehensive view of the competition issues raised by their business activities. This effort is being coordinated at EI by Philip Nelson.

## Private Price Indices . . . (Continued from Page 1)

to be reliable indicators of actual prices than if different surveys produce significantly different prices.

Finally, comparing actual transactions with price indices can verify the accuracy of the indices. A central tenet of statistical analysis is that a sample can provide accurate information about the expected average value of the actual data. Thus, examining transactions from even a small share of total industry transactions is likely to indicate whether the price index accurately portrays price movements in the market. Industry participants often have enough data from their own buying and selling activities to judge the quality of published price indices in this manner.

Applying these principles to the case of gas prices in California indicates that the published price indices likely reflect the average of actual transaction prices in California. Although FERC staff correctly observe that reported California gas prices were not correlated with prices in the producing basins during the refund period, that does not mean the prices are not accurate. The lack of correlation in this case appears to have been caused by the capacity constraints on pipelines that affected shippers during the refund period. Prices would not likely be as highly correlated when facilities are constrained as when they are not constrained. Deliveries into the SoCalGas system were at maximum volumes during most of refund period, so the SoCalGas gas price would not be expected to be correlated with other prices.

Other indicators of accurate price reporting suggest that the reported California prices reasonably measured changes in average actual prices. The established indices, especially the *Gas Daily* daily mid-points and *NGI* monthly prices, are used for a substantial volume of transactions, which supports a strong presumption that they accurately reflect market conditions. Price indices from the different publications are all highly correlated, which indicates that they reported a consistent set of prices. Finally, comparisons with actual transactions also support the accuracy of the reported prices. Electric generators demonstrated that their average prices for natural gas closely tracked the *Gas Daily* mid-point prices. Their price data excluded transfers and trades that were subject to the FERC staff's allegations of manipulation. The comparison shows that the average of actual prices followed the published prices closely, with the average of actual prices being within 3 percent of the average of published values.

*Principal John R. Morris leads the energy practices at EI. He has consulted on the use and misuse of published price index data.*

## Recent Court Judgments . . . (Continued from Page 3)

European merger need to go beyond a simple assertion that these anticompetitive effects *cannot* exist. Leverage and exclusionary effects theories appear to receive more serious attention in Europe than in the United States.

The Court's judgments have also made it clear that in advancing concerns of post-merger anti-competitive behaviour, the Commission needs to do more than just refer to a theoretical economic model. It also must articulate clearly which particular theory of anti-competitive effects it considers to be relevant and test the theory against the facts of the industry. This is the fundamental weakness in the approach adopted by the Commission in its recent merger policy and one that has been so dramatically unveiled by the Court. The three judgments have shown that the Commission has often been too ready to listen to competitor complaints, based loosely on one or more of the many new economic theories of co-ordinated or exclusionary effects, and to adopt them uncritically into a case against a merger.

The Commission apparently understands the critical importance of these lessons. At a recent conference in Brussels on European merger control, Mario Monti, the Director General of DG Comp, outlined a series of proposed reforms including the creation of a new position of Chief Competition Economist "with the staff necessary to provide an independent economic viewpoint to decision-makers at all levels, as well as guidance throughout the investigative process." Other proposed reforms ensure that parties will have access to the information available to the Commission in a more timely fashion, which should enable them to respond more effectively to the concerns expressed by the Commission and to the complaints put forward by third parties.

The proposals demonstrate the Commission's willingness to improve the thoroughness of its substantive analysis, and it is to be expected that rigorous economics based on a thorough consideration of the facts of the case will play a greater role in its future merger decisions.

*Andrea Lofaro is a partner with RBB Economics. His consulting experience includes work on numerous Phase II Merger Regulation cases and on several high profile cartel cases. He has also published a number of articles on competition policy and industrial economics.*

# Economists Incorporated

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| Suite 400 | Suite 250 |
| 1200 New Hampshire Ave. | 5980 Horton Street |
| Washington, DC 20036 | Emeryville, CA 94901 |
| Phone: (202) 223-4700 | (510) 547-6910 |
| Fax: (202) 296-7138 | (510) 547-5162 |

Website: www.ei.com

President, Jonathan L. Walker; Editor, David A. Argue
Layout, Crystal D. Simpkins

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