NERA at 40: Making Markets Work Better

Why is it that you can pay $449 to fly from London to New York while the woman in the next seat can take the same flight, watch the same movie and eat the same bad food for only $299? What possible harm could come to consumers when a software company gives its product away? And what is the stock market telling us when two firms miss their earnings estimates by mere pennies but only one firm's share price takes a hit?

These questions are just a few examples of those encountered in the brand of economics National Economic Research Associates (NERA) and its consulting economists have been practicing for 40 years. As opposed to macroeconomic issues such as gross national product, tax cuts and inflation, NERA's work is in microeconomics, which deals with individual industries, companies and groups of consumers.

It's a field that is "micro" in name only, since the dominant factor in any country's economic vitality is how well its markets work. The vigor of competition, the quality of regulation and the integrity of financial institutions are the sources of efficiency in markets, and NERA works for clients to advance these causes. In fact, the firm's stock in trade is a deep understanding of how markets work.

"We are the principal appliers of economic insights to practical problems at the level of consumers and businesses," says NERA president Richard Rapp. "Economic theory is a wellspring of both creativity and analytical rigor for us. But clients retain us for practical reasons. They find us equipped with deep institutional knowledge in specific industries and markets, as well as the requisite tools. Value is created in markets, and to understand the sources of value it's necessary to have a firm grasp on both the theory and the facts."

EVOLUTION OF A LEADER

NERA's story began in 1961, when the newly formed 17-member firm started working on natural gas field price matters. Those initial assignments led to work in the U.S. utilities industry involving state regulatory commissions and antitrust work in a range of industries.

NERA experienced a rapid growth spurt during its second decade. In addition to groundbreaking work involving the Arab oil embargo and various government and private entities in the U.S. energy sector, the firm's economists expanded their consulting work across a variety of disciplines, including communications, shipping/transportation, consumer products and sports economics.

In its third decade NERA continued to evolve and expand. In February 1983 the firm was acquired by MMC. During this time NERA also entered into global markets, establishing practices in the United Kingdom and Spain to assist governments in those countries with privatization.

"The privatization of the U.K. electricity industry was a groundbreaking assignment for NERA," says Mr. Rapp. "It proved that economists could be useful in previously unrealized ways. Since those initial assignments, assisting governments and utilities in the transformation from state-run industry to regulated monopoly to competitive market has become a very large, worldwide line of business for us."

During that same period, NERA was involved in several high-profile antitrust and competition policy cases, including the breakup of telecommunications giant AT&T. By the end of its third decade NERA had a staff of 300 in 11 offices around the globe and ranked as the world's only truly international economic consulting organization.

NERA TODAY

Today NERA's 400-member staff includes some 300 consulting economists, the vast majority of whom hold doctorate degrees in economics or related disciplines. In addition to nine U.S. locations, the firm has offices in Brussels, London, Madrid and Sydney and handles assignments around the world. Its economic consulting services are concentrated in two primary areas: advisory services, and law and economics.

NERA's advisory services work helps clients shape business strategies by anticipating the evolution of competition and regulation and measuring the impact of likely developments on the profitability of a company or the economic evolution of a country. NERA also provides advice on strategic issues and risk management and was a pioneer within MMC in the modeling of risk on an enterprise-wide basis.

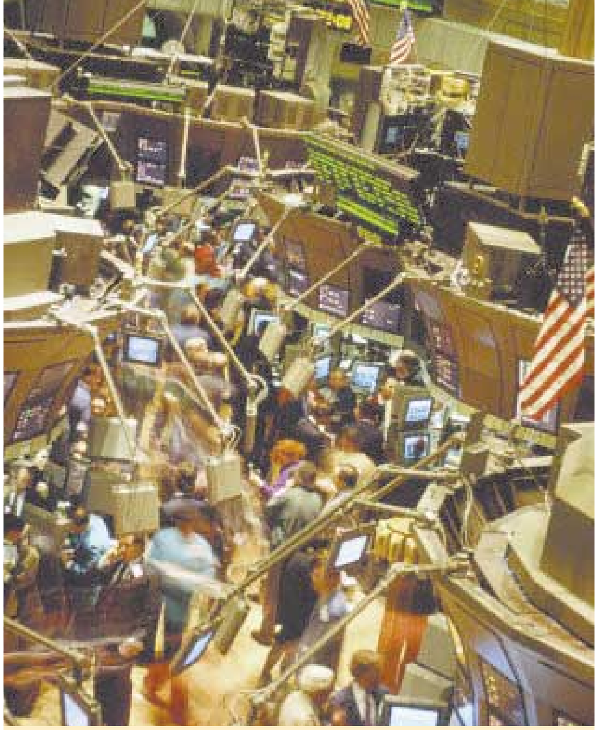
"As a firm we're organized along practice lines, such as energy, securities, competition policy and intellectual property, and our advisory work is growing in all those practices," says William Baker, NERA's London-based advisory services coordinator. "In addition to advising companies, a number of our projects are for governments and regulators. For example, we may go into a developing nation, study its energy sector, assess the institutional structures and advise the government on how to improve the situation."

In such cases, NERA consultants may propose a new energy law or develop recommendations for a new institutional structure. They may also develop the framework for a new market, indicating the form of regulatory oversight that would be most appropriate. Subsequently NERA may be retained to develop the regulatory structures and assist with privatization by drawing up contracts, outlining appropriate bidding processes and working closely with investment banks to make it all happen. In later stages NERA consultants may be involved in evaluating the bids and providing additional advice to the privatized entity or regulating body.

"Our advisory assignments in emerging countries are often in conjunction with the World Bank, although they can be for the host government," says John Rhys, managing director of NERA in London. "What we're often trying to gain, particularly in regulation of utilities, is an increased ability to raise private-sector finance. In the widest sense, it's interpreting the regulatory bargain between the monopoly and its consumers. In exchange for the right to have the monopoly, the company has to submit to regulation and behave reasonably well. The regulation is really about interpreting the agreement in a way that is satisfactory to all parties."

In the last 10 years NERA has completed advisory projects in more than 100 countries. Regardless of where a project takes place, the firm puts together the best team for the task by calling on economic consultants from NERA offices around the world. It's a technique NERA used as it developed and implemented reforms in the electricity sector in the states of Orissa, Haryana and Andhra Pradesh in India, and as it participated in major reforms of the regulatory framework – often including restructuring and privatization – in many other countries. NERA's experiences in energy sector reforms now extend to countries in Western and Eastern Europe, virtually every economy in the Asia-Pacific region, many in Africa and others worldwide.

International groups of NERA consultants are currently involved in major projects in Singapore, where



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40 YEARS OF MILESTONE EVENTS

NERA solves complex business and legal issues arising from competition, regulation, public policy, e-commerce and strategic business decisions. The firm is known globally for its work in market strategy and design, antitrust/competition policy and deregulation of the world's energy, utilities, transportation and communications industries. Here's a look at some of the milestone activities NERA has been involved with:

Deregulating the world's industries

NERA has played a key role in establishing fair and efficient markets in the deregulation of the U.S. and European energy and communications industries, as well as the U.S. airline and gaming industries.

Determining the value of intellectual property

NERA economists establish strategies that maximize the potential of intellectual property, including if and how to license intellectual property and determining its value. NERA's expert reports have helped resolve hundreds of intellectual property disputes.

Determining the value of class action suits

The testimony of NERA's economists has been critical in establishing a fair assessment of damages in many high profile U.S. class action suits, including those against Dow Corning, American tobacco companies, gun manufacturers and health-related agencies.

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NERA's auction specialists have played a role in virtually every wireless spectrum auction, in many cases helping bidders develop strategies that save them billions of dollars.

they are working with corporations and government bodies on telecommunications, gas, electricity and transportation advisory assignments.

INFLUENCING AUCTIONS WORLDWIDE

Auctions have existed since the early days of commerce, but in many ways they're an ideal market mechanism for the 21st century. For many public and private entities in today's global economy, auctions have become a preferred means of reconciling supply and demand and creating opportunity on both sides of the economic equation.

High-tech, communications, electric power, e-commerce and other markets have all reaped enormous benefits from the effective use of auctions in recent years, as has NERA, which fields one of the world's most experienced teams in terms of auction design, advocacy, strategy, implementation and logistics management.

"Our auction practice is one of the most technically demanding in the firm, and only superstars in game theory need apply," says Mr. Rapp. "We advise on setting up auction rules or we advise a party on its bidding strategy and tactics. Every setting is different and the stakes are never small."

Wireless spectrum auctions – where companies bid for ownership of frequency ranges for new wireless networks – have been a key area for NERA. The firm's senior auction specialists have played a role in virtually every wireless spectrum auction, in many cases helping bidders develop strategies that save them billions of dollars.

ECONOMICS AND THE LAW

Through its law and economics discipline, NERA assists companies, legal counsel and government entities by providing objective analysis, expert testimony and related services. NERA consultants apply specialized institutional knowledge, accounting expertise and econometric skills to answer questions arising from numerous legal actions, including insurance and securities litigation, class action suits, insider trading and bankruptcy proceedings.

Several of the firm's areas of specialty, including mergers and acquisitions, product liability/mass torts, and antitrust and intellectual property disputes, place it in the middle of battles that are waged not only in courtrooms but in the media as well.

Among the NERA assignments surrounded by the greatest media fanfare are those involving its antitrust and competition policy practice. In cases that have received international press coverage, NERA consultants have worked on behalf of Microsoft, Visa, American Airlines and British Airways in actions brought about by governments and enforcement agencies regarding dominant power claims and monopoly charges.

Similarly, NERA specializes in analyzing trade practices to evaluate the competitive impact of proposed mergers and acquisitions. In transactions such as the $23.7 billion deal between Bell Atlantic and NYNEX, Exxon's $87 billion purchase of Mobil and the AOL/Time Warner mega-merger, NERA consultants provided critical analysis of the implications on price, market power and value.

"When two firms want to merge

40 YEARS OF MILESTONE EVENTS *(Continued)*

Defining new market structures

NERA is a pioneer in developing markets for electric power and was instrumental in the early introduction of competition into generation. In today's emerging auction markets, the firm's auctions team assists in market design and devising bidding strategy and tactics.

Determining what constitutes abuse of monopoly power

NERA has prepared testimony in many of the world's largest antitrust/competition policy cases, including Microsoft, British Airways, American Airlines, Visa and Borders Books. The firm has proposed new ways of evaluating competition policy in a business environment characterized by compressed product lifecycles and shrinking windows of opportunity.

Identifying trends in shareholder class action suits

NERA is an authoritative source for data and analysis on shareholder class action suits. With its securities experts, sophisticated statistical techniques and a proprietary database of case characteristics, the firm explores the factors that drive trends and predicts settlement values in ongoing cases.

they're usually required to get government approval," says NERA senior consultant Elizabeth Bailey. "We help firms anticipate where the government is likely to raise concerns and help them explain to the concerned body how the merger will lead to a pro-competitive situation. In other instances we get involved a little later in the process, when the firms are already embroiled in discussions with the government and need help negotiating and working through the concerns."

In yet another area of specialty, mass tort cases such as those brought against manufacturers with asbestos liabilities, NERA's advice and analysis have been instrumental in resolving the disputes.

"In the early 1990s we were approached by counsel for National Gypsum, which had declared bankruptcy as a way of bringing its asbestos liabilities under control," says NERA senior vice president Frederick Dunbar, who led the firm's securities and mass torts practice for 10 years. "We were asked to determine if the trust fund established by National Gypsum would be sufficient to fund future liabilities. We did that and testified in bankruptcy court on the matter. Since then we've played a part in well over 30 similar cases involving asbestos liability. In each case we determine the scope of future liabilities, whether the amounts being paid are reasonable and if alternative methods of handling the liabilities would be more economical."

NERA's decision to work with a client is based on an objective, clinical analysis of the circumstances. The firm – which has testified in court cases for plaintiffs as well as defendants – declines assignments when a prospective client's position doesn't square with the economics.

"We're not taking a public policy stand when we accept an assignment," says Mr. Dunbar. "In fact, we're frequently approached by parties on both sides of an issue. When that happens we consider what an objective economist would say on the matter and work with the client for whom that objective testimony would be most helpful. It's an approach that's precisely in line with our scientific view of economics. The more our testimony resembles a lab report the better, since completely objective findings are always the most robust under courtroom attack."

THE NEXT 40 YEARS

As markets throughout the world continue to evolve, NERA will remain heavily involved in areas of regulation, privatization and public policy. The firm will also maintain its traditional involvement in litigation and its various other specialties.

In terms of future plans, NERA will expand its role as economic advisor to corporations and strengthen its ties to its clients' overall strategic planning processes.

NERA took a signicant step in those directions earlier this year with the introduction of its risk management product, c-far (cash-flow-at-risk), a new method for non-financial companies to measure their cash flow volatility.

"As opposed to the rule-of-thumb approach firms have relied on until now, c-far produces a quantitative measurement of cash flow volatility," says Louis Guth, head of NERA's securities and finance practice. "With that answer, firms can determine the level of risk they're willing to tolerate and go through various stages of analysis with our colleagues at Marsh to mitigate that risk."

Regardless of how markets around the word adapt to the ever-changing global economy, there will always be a critical role for NERA, as Mr. Rapp explains.

ÒNERA will continue to thrive because very important decisions are made in regulatory bodies, the courts and the worldÕs markets, and those decisions depend upon getting the economics right,Ó he says. ÒWe get the economics right.Ó

For more information visit NERA's website at www.nera.com.

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