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Electricity: Notes on the Transition Phase

*Albert A. Foer**

I. INTRODUCTION

By now we have had experience with numerous transitions from regulation to competition, both at home and abroad. Although there is a debate about how swiftly such transitions should occur, all agree that there is located between the starting point of governmental Regulation and the promised land of market-based Competition, a Transition Phase. Electricity is—and may remain for quite a while—in a Transition Phase.

When deregulation is being considered, advocates and opponents naturally cast their arguments in terms of the beginning and the end, with relatively little attention to the middle. After all, until the public, the industry, and relevant governments are sold on the end (or, conversely, in not commencing the process of deregulation in the first place), there is no point in even talking about the middle passage. If it is Pike's Peak to which we are traveling, let's cast our eyes upon the gold-bearing distant mountains and not the unbridged rivers that must be crossed.

The Transitional Phase, however, is inevitable and enormously important. What happens in the transition determines not only whether there will be a promised land but, if so, the nature of its terrain. Moreover, public policies that may be appropriate during one phase will be inappropriate in another, and this can lead to fundamental errors unless policy-makers carefully relate their policies to the phase. There are strong reasons to doubt that this is being done consistently in the deregulation of electricity.

The Transitional Phase is the most difficult to envision *ex ante*. The status quo, the starting point, the regulated industry, has almost by definition been around for a long time and has been thoroughly mapped and critiqued. The promised land, though a figment of the future, can

* Albert A. Foer is President of the American Antitrust Institute, www.antitrustinstitute.org. The encouragement of AAI Advisory Board member Spencer Weber Waller and the contributions of the AAI's Diana Moss, Geoffrey Shepherd, and David Penn are gratefully acknowledged.

be easily visualized, because it reflects the competitive model, something we are familiar with theoretically and (albeit in other industries) empirically. But the Transition Phase is not easily modeled. It is essentially chaotic, and it is singular. That is, no other industry has moved from precisely the same starting point, and therefore the starting assumptions are unique. As complexity theory tells us, prediction is difficult because variations in the starting assumptions can lead to very different paths as a process unwinds into the future.

II. THE PARADIGM OF REGULATION TO TRANSITION TO COMPETITION

Before we turn to the deregulation of electricity, let us go a bit further in sketching out the general paradigm of Regulation to Transition to Competition.¹

An industry is characterized as subject to intensive economic Regulation, when important decisions relating to the industrial organization of the industry are made by public officials. Typically, this involves pricing, profits, entry and exit, and terms of doing business. In electricity, all of these elements were (and to a large extent still are) regulated by a mixture of federal, state, and even regional officials.

Typically, the regulated industry is to a significant extent monopolistic in structure. In electricity, it was long believed that generation, transmission, and distribution could most efficiently be provided by a vertically integrated natural monopoly called a public utility. This is not to say that there are no elements of competition, but compared to the role of monopoly, competition is minimal. The vertical structure raised classic problems of access to outsiders, a problem that remains even after deregulation as long as some parts are natural monopolies.

The culture of a regulated industry tends to reflect the monopolistic nature. That is, on the business side the driving incentives relate to reliability and predictability, rather than entrepreneurship, cost-cutting, or low consumer prices. Similarly, the regulators tend to be paternalistic, feeling an obligation (re-enforced by legislation and politics) to the industry's well-being, to assure the reliability and predictability promised to consumers and shareholders.

1. One is tempted to call this paradigm electricity's answer to baseball's legendary double play combination, "From Tinkers to Evers to Chance." Are baseball names prophetic? If you merely Tinker with Regulation, you will not get to Competition. If you linger for Ever in Transition, you will not get to Competition. And if you think that Chance will get you to Competition, you have dropped the ball. With apologies to Mr. Justice Blackmun.

Skip past the Transition Phase for a moment to the Competition Phase. Here the emphasis is on the interplay of supply and demand, rather than Regulation, to determine output and prices. Terms of trade are to be determined by the competitive struggle of rivals to gain competitive advantage. Conditions of entry and exit are set by economic forces rather than by government decisions. The assumption necessarily underlying this is that there will be a sufficient number of competitors to have a workable form of competition.

Instead of economic Regulation by the government, there will be antitrust regulation, which implies a lighter, less frequent and generally post-hoc form of public intervention. (Economic Regulation tends to be prophylactic whereas antitrust tends to be reactive.) The sovereign government is replaced, for the most part, by the sovereign consumer.

The culture of Competition is entrepreneurial. Private decision-makers must have a concern for reliability, because consumers will respond to service quality as one dimension of the multi-component value package they are evaluating when they choose among competing marketers. But consumers will also focus on price, and so competing providers will necessarily pay more attention to how they can reduce the price of their offerings than was necessary under Regulation, where regulated pricing aimed at being lower than monopoly pricing but high enough so that returns would attract investors. Indeed, it is the promise of lower prices that inspires the initial policy decision to enter upon a course of deregulation. The entrepreneurial spirit has two other features of note. First, it is inventive, creative, and mold-breaking, as it seeks to build that famous better mousetrap that will lure new customers. At the same time, however, it is bottom-line oriented. Because of shareholder pressure, this usually means that management focuses on the profitability of the next quarter rather than longer-range (whereas the regulated monopoly could focus on the longer-range), and the result is that costs must continually be monitored and clipped (whereas according to a famous but not always true economic theorem, the regulated monopoly often had an incentive to build costs into the rate base as part of a strategy to increase returns to investors).

Thus, as we look at supply and demand, in the Competition Phase, the supply component needs to be characterized by a different, more entrepreneurial mentality than was present in the Regulation Phase. It is similar on the demand side. Whereas consumers of a heavily regulated service did not have to make choices, in the Competition Phase it is necessary for them to evaluate competing offers and to select among them. This means that they must spend time learning new vocabularies, comparing offers, and dealing with multiple suppliers, compared to the

one-stop shopping that was characteristic of Regulation. Consumers' transaction costs go up and not all consumers are equally capable of handling their new role.

The culture of regulators is also quite different under a regime of economic regulation and a regime of antitrust. The economic regulator focuses, as noted above, on making sure the regulated industry runs in accordance with the public interest, as defined centrally by statutes and regulations. The antitrust enforcer focuses, instead, on maintaining the process of competition. The former is concerned with reliability, the latter with prices, choice, innovation, and (above all) keeping decision-making decentralized.

III. TASKS OF THE TRANSITION PHASE

The Transition Phase, quite simply, has the mission of moving not only the regulated industry, but also regulators and consumers from Regulation to Competition.

The Transition Phase has received the most attention in terms of what happened in Eastern and Central Europe after the fall of communism. Nation after nation (often newly established as independent) opted to move from socialist to free market. The mission was daunting and has proceeded with dramatically varying degrees of success. Among the tasks are the following:

- Dismantling of public monopolies through privatization,
- Creation of the basic institutions that are necessary to free markets (including laws protecting private property, development of capital markets, and emergence of independent judiciaries),
- Passage of competition policy laws, development of competition policy agencies.

Great controversy surrounded each of these tasks because there were so many different ways in which each could theoretically be directed. Equally noteworthy was the controversy over the pace at which the transition should be attempted and the priorities that should be assigned to the various tasks and subtasks that would need to be accomplished. One set of voices called for "the Big Bang" by which as much as possible would be done more or less simultaneously and rapidly. The Transition Phase, in this view, should be short and abrupt, taking advantage of the popular support for radical change and avoiding a prolonged period during which opposition would inevitably congeal. The major competing camp called for a much slower, step-by-step pace, on the recognition of the complexity of the transition and the fear that the Big Bang would lead to the Big Collapse.

The deregulation of electricity raises the same kinds of questions that I will now pose as keys to the Transition Phase. Assuming a popular objective, how can the incentives for integrated firms to discriminate against their downstream generation competitors be eliminated or sufficiently dampened? How will multiple competitors be brought into existence? What functions *can* (generation), *cannot* (transmission), and *might* (distribution) be deregulated? How will deregulated parts relate to those that remain regulated? How will the management of the firms that are deregulated become acculturated to competition? What role will regulators play during the deregulating process? How should the change from FERC oversight to antitrust oversight be made, in terms of laws, in terms of budgets, in terms of who the decision-makers will be and how they view the world? How will consumers be protected as regulation diminishes? How will they be trained for their new role? And, how rapidly should we try to do this?

IV. ANTITRUST IN THE TRANSITION PHASE, BETTER TO BE CALLED COMPETITION POLICY

Because the Competition Phase will be subject to antitrust rather than governmental economic regulation, there is a tendency to believe that antitrust will dominate the Transition Phase. I would propose that we speak in terms of competition policy rather than antitrust, recognizing that the Transition Phase must combine aspects of economic regulation and antitrust. Placing too much faith in the ability of antitrust during the Transition Phase is one of those misplacements of policy that can be devastating to the process.

Antitrust generally serves the function of maintaining competition. (Indeed, "Maintaining Competition" is the official name of the antitrust mission at the FTC.) That is, antitrust enforcement (public or private) can stop anticompetitive behavior in industries that are more or less competitive. It can block two companies in a concentrated industry from merging, thereby preserving the industry from further concentration. Antitrust by itself has rarely been able to take a non-competitive industry and make it competitive. A company can gain a monopoly without violating antitrust laws. Even after it violates antitrust laws, there is little likelihood that the government will break up a company in order to bring to life a more competitive industry.

The central task of a Transition Phase, however, is not to maintain competition (which had at most a minimal role during Regulation), but to generate competition. This is a more positive mission that utilizes principles common to antitrust, but it is a mission that might better be

described as “industrial planning” or, to focus on the importance given to the desired end result, “competition policy.” Another way of stating this is that, at least when you are starting with something other than a theoretical state of nature, free markets are not natural. They come embedded in institutions and those institutions must be visualized, then created, then nurtured by governmental policies. The Transition Phase should be seen as an evolving form of Regulation, Regulation to Create Competition. There will likely be a continual and important role for regulatory agencies like FERC through their authority to use generic policy initiatives (e.g., rulemakings, notices of inquiry, etc.) to promote the Transition to Competition and perhaps even to maintain Competition once established.²

V. MERGERS AND THE TRANSITION PHASE

Regulated companies are well experienced in gaming the regulatory system. As they look toward a future of deregulation, they react by trying to figure out how they can stay in control of their environment. One obvious way is to get ahead of the curve by consolidating with similar companies who would otherwise be potential competitors in a free post-deregulation market.³ Many and large have been the public utilities that were merged out of existence as the electricity deregulation process geared up.

Here we have an excellent example of misplaced policy. Competition policy, recognizing that a Transition Phase has to generate new competitors, would place a temporary moratorium in concentrated markets, or at least a heavy burden of demonstrated need, on consolidation, so that there will be a workable number of competitors when we arrive at the Competition Phase. Antitrust, however, would treat merging utilities under its standard merger guidelines, focusing primarily on whether the utilities currently overlap with each other. Finding that they do not, there is usually insufficient reason to stop the merger. Getting ahead of the game, the U.S. has approached electric utility mergers as if we were already in the Competition Phase.

An issue that keeps arising in Congress is whether FERC or the federal antitrust agencies (the Antitrust Division of the Department of Justice and the Federal Trade Commission) should oversee mergers. No

2. Or, as I have put it elsewhere, what is needed is a period of Shermanization before the industry will be ready for Sherman. Albert A. Foer, *Institutional Contexts of Market Power in the Electricity Industry*, *ELECTRICITY J.*, May 1999, at 13-20.

3. Of course there are also more efficiency-oriented motivations to merge, such as to integrate into upstream transmission/fuel supply or downstream product diversification.

distinction is made between the Transition Phase and the Competition Phase. During the Competition Phase, primary responsibility should certainly rest with the antitrust agencies. But, in the Transition Phase there are at least three reasons why FERC should continue to play a primary role:

- FERC has a “public interest” responsibility that gives it the potential for taking a more pro-active position than the antitrust agencies in shaping an industry for competition.
- FERC has deep expertise in the highly complicated electricity industry, not matched by the antitrust agencies. This expertise is especially needed during the Transition Phase.
- The interplay of FERC and the antitrust agencies allows both regulatory and antitrust concerns to contribute substantively to decisions, at a time when neither one nor the other, but a combination of the two, is needed.

VI. MARKET MONITORING AND THE TRANSITION PHASE

It has become clear that the deregulation of electricity is moving into a part of the Transition Phase that emphasizes “market monitoring.” That is, many electricity markets are already relying on competition to determine the behavior of firms, even though the institutions of competition are far from in place. It is becoming recognized as necessary to monitor electricity markets to see if they are in fact operating competitively so that state and federal regulators can know when (and perhaps how) to intervene when competition is failing to achieve acceptable results. How and what types of market monitoring best promote the development of competitive electricity markets is a wide-open question.

In the context of planning a workshop on market monitoring, Dr. Diana Moss, Senior Research Fellow of The American Antitrust Institute and a former economist of FERC responsible for evaluating the competitiveness of markets, has identified the following questions, presented here as an indication of the complexity involved.⁴

A. What to Monitor and Who Should Do It

What criteria should be used to determine if market monitoring is needed? Should criteria be based on market structure and/or market design? How does the type of product and market geography influence

4. Dr. Diana Moss, Workshop on Electricity Market Monitoring, American Antitrust Institute (Dec. 11, 2001), available at <http://www.antitrustinstitute.org/recent/166.cfm>.

the need for monitoring? How does the presence of centralized or decentralized market mechanisms affect the need for monitoring? Is market-monitoring here to stay? Under what circumstances could market monitoring be phased out? How can the objectives and implementation of market monitoring best promote competitive market development and outcomes? FERC recently announced that utilities in Commission-approved RTOs will not be required to file for or renew their authority to charge market-based rates. What does this policy imply for who will assume the bulk of the monitoring responsibilities? How will RTOs and FERC coordinate on monitoring issues and compliance? Are there other entities that are likely candidates for market monitors? How will FERC and the RTOs (or others) interact to ensure that market monitoring is performed consistently and effectively? FERC has established broad policy goals for implementing market-monitoring programs. To what extent should FERC develop specific criteria to ensure consistent standards and implementation? To what extent should states develop monitoring programs for retail electricity markets? What can we learn from the market surveillance experience in the securities industry and other commodity markets?

B. Detection and Enforcement

What are the criteria for detecting deviations from firm conduct that promotes competitive market outcomes? How have those criteria been employed in current market monitoring programs? How do detection criteria compare/contrast across RTO's? How tightly are monitoring plans tied to market designs, and what are the advantages and disadvantages of a system that does not employ standard criteria? Does it make sense for FERC to develop standard detection criteria? What analytical tools are employed in the process of monitoring markets? Are behavioral market models useful in evaluating firm conduct in the market monitoring context? What issues arise in an environment where market structures and market designs change rapidly? What analytical tools are useful in such an environment? What is FERC's likely role in the coordination of broader-scale monitoring efforts? How will FERC, the RTOs and other possible monitoring entities share monitoring information and data? Are there any lessons to be learned from the market monitoring experience to date? How do the antitrust enforcement agencies see their role in monitoring electricity markets? Under what circumstances would antitrust enforcement agencies independently pursue violations detected under market monitoring programs?

From this recitation of issues, it is apparent that the interplay of antitrust and regulation, or rather what we can jointly speak of as Competition Policy, is a highly complex enterprise that is not going to be worked out quickly or easily. The context is not one of theoretical constructs but of pragmatic considerations involving balancing, trade-offs, and predictions that may have to be revisited with frequency.

VII. INFORMATION AND THE TRANSITION PHASE

The kinds of information that are needed by regulators who monitor markets or who must oversee a Transition Phase and periodically evaluate markets to see if competition is working, may be different from what is needed by antitrust enforcers in a Competition Phase, where the purpose of information is largely to prosecute violations after the fact. It is another misplacement of policy for the government to reduce the information that is needed during a Transition Phase, as if we were already in a Competition Phase. Yet this seems to be happening. For example, the Energy Information Administration (of the Department of Energy) and FERC have launched initiatives to no longer require the disclosure of certain plant-level information that has been useful in market monitoring.

VIII. CONCLUSION

Public policy toward the deregulation of electricity needs to take recognition of the three-stage paradigm of Regulation to Transition to Competition. Each stage is fundamentally different and requires policies that are stage-appropriate. Failure to make these distinctions can lead to catastrophic failure of the deregulation process. In the case of electricity, catastrophic failure can be deadly to human beings and devastating to the economy.