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*Utility Entry into Telecommunications:  
Exactly How Serious Are We?*

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# Utility Entry into Telecommunications: Exactly How Serious Are We?

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## I. Introduction

When the Telecommunications Act was enacted over two years ago, both politicians and pundits alike promised consumers that they would receive a plethora of competitive benefits as the great tectonic plates of domestic and international telecommunications industry structures ostensibly began to shift. One of the fundamental forces behind this great tectonic shift is supposed to come from the utility industry who — with their existing assets, rights of way, expertise and corporate culture — are well-positioned to make an immediate and positive contribution towards the acceleration of facilities-based competition for telecommunications and information services. Despite this stated goal of achieving “competition” and “deregulation” in the telecommunications industry, however, it nonetheless appears that new facilities-based entry in general, and new facilities-based entry by utilities in particular, has not been as rapid or as substantial as the politicians promised originally.

While certainly a large portion of the blame for the lack of *any* kind of sufficient facilities-based entry (and the corresponding lack of improvements to market performance) lies squarely at the feet of the FCC,<sup>1</sup> examining the particular issues affecting utility entry specifically is a far more complex task. For example, it is impossible to talk accurately about utility entry into telecommunications without also understanding how FERC and the states’ regulatory attempts to promote ostensibly “competition” and “de-regulation” affect adversely utility strategic planning. As explained more fully below, because these restructuring initiatives are more interested in the improper reallocation of wealth rather than the proper maximization of consumer

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<sup>1</sup> See, e.g., Steve Lohr, Giving Old Ma Bell New Lease on Life, More New Math: Promoting Competition by Addition, Not Division, *NEW YORK TIMES* (May 12, 1998) at D1.

welfare (*a.k.a.* “neo-competition”<sup>2</sup>), utilities are now often too busy defending their core business to have the time — and, in many cases, even just the inclination — to enter an ancillary business. Conversely, even when utilities *want* to enter ancillary telecommunications markets, either over-zealous or (as is very often the case) captured regulators prohibit them from doing so in the name of protecting “fair” competition and consumer welfare. It is also impossible to talk accurately about utility entry into telecommunications without identifying the surprisingly large and diverse constituency of parties which (to put it politely) are not exactly thrilled with the idea of utilities getting into telecommunications, and how this constituency has managed to exacerbate greatly the probability that the regulatory process will delay or deter utility entry.<sup>3</sup>

As such, this article explores briefly some of these issues, and proposes to ask a very fundamental question: If meaningful, facilities-based competition and “de-regulation” for telecommunications and information services (and, *a fortiori*, competition and de-regulation for electricity as well) really is the end-goal of this whole “restructuring” exercise now under way, then exactly how serious are we about specifically permitting and promoting utility entry into telecommunications and information services markets? If the answer — as it

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<sup>2</sup> I describe deliberately this type of public policy as the improper promotion of “neo-competition” because, although Justice Felix Frankfurter warned over forty-five years ago that the term “competition” may not be viewed in an “abstract, sterile way,” it nonetheless appears unfortunately that over the last five years, both antitrust enforcement and major public policy regulatory initiatives have ignored Frankfurter’s caveat by recasting the end-goal of “competition” (which, through rivalry, attempts to maximize consumer welfare by producing dynamic and static economic efficiencies) to something more akin to “fair, competition-like outcomes accompanied by the benevolent use of ‘market-friendly’ regulation.” In other words, competition is a zero-sum game. In so doing, the concepts of “antitrust,” the “public interest,” and “competition policy” appear no longer to bear any nexus to their original core purpose: the maximization of consumer welfare. By blatantly disregarding (or, to use current parlance, “re-inventing” or “moving beyond”) basic economic first principles, it is very unlikely that such policies will produce, and accordingly permit consumers to enjoy, the economic benefits associated with good market performance — i.e., declining prices and additional new services and products. Instead, by tragically becoming the de rigueur intellectual buzzword of the nineties, these policies have reduced the concept of “competition” to nothing more than an effective “smoke screen” to advance flawed economic theories that were soundly discredited the first time they were run up the flagpole. See Lawrence J. Spiwak, Antitrust, the “Public Interest” and Competition Policy: The Search for Meaningful Definitions in a Sea of Analytical Rhetoric, ANITRUST REPORT (Matthew Bender, December 1997) (“The Search for Meaning”) at 2-3.

<sup>3</sup> See, e.g., Massachusetts Attorney General Weighs in on RCN-Boston Edison Complaint, COM. DAILY (March 2, 1998); Bruce Mohl, Cable Firms Assail RCN, [Boston] Edison Venture; Say Utilities to Subsidize Project, THE BOSTON GLOBE (Aug. 15, 1997) at C3; Nebraska Attorney General Okay’s Ban on Electric Utility Entry into Cable, COMMUNICATIONS DAILY (July 14, 1997).

should be — is affirmative, then public policies should therefore stop erecting regulatory barriers to utility entry in the name of protecting “consumer welfare.”

## II. Comparing the Structural Economic Characteristics of the Electric Utility and Telecommunications Industries

Many people think that because the telecommunications and electric utility industries both use poles and wires, these industries are the same (and therefore should be regulated identically as well). Wrong. Despite the fact that the telecommunications and electric utility industries both use poles and wires, the similarities basically end right there. These are very different industries, with very different structural (and even cultural characteristics) and, as such, merit neither homogeneous analysis nor regulatory treatment as well.<sup>4</sup>

As an introductory matter, it is crucial to understand that telecommunications and electric utility networks *operate in fundamentally different ways*. On one hand, an electric utility essentially provides three basic functions: (a) generation; (b) transmission; and (c) distribution. Electricity, however, is not a “commodity” in the conventional sense of the term, such as wheat, pork bellies or frozen concentrated orange juice. It cannot be stored, stacked, or even touched; rather, because under of the laws of physics, electricity always seeks to follow the path of least resistance, electricity may only either be used or lost (*i.e.*, “grounded”). As such, there is no clear point of demarcation between the interstate transmission and local distribution facilities of a utility’s network. Indeed, a utility’s network is more than just a grid system of powerlines. A utility network is a complex infrastructure with a large investment in monitoring and operating equipment with its associated communications networks and computers. To wit, power problems in Arizona

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<sup>4</sup> A classic example of this type of analytical obfuscation can be found in a paper authored by advocates for municipal utilities and RBOC interests. See, e.g., William D. Steinmeier, et al., *The Cost of Ignoring History* (Unpublished Manuscript). There, the authors argued that the FCC should adopt an embedded cost methodology — rather than a total element long-run incremental costs methodology — in setting the appropriate pricing methodology for interconnection and network elements, simply because FERC had used embedded cost methodology. The problem with such a pedantic approach, however, is that it ignores the caveat I offered above — *i.e.*, just because the electric utility and telecommunications industries both use poles and wires, the similarities end right there. Accordingly, the key issue is not to argue the merits and faults of FERC’s actions versus the FCC’s actions, but to determine *sua sponte* the correct pricing methodology — as well as other regulatory restraints — that should be imposed in light of the specific underlying structural characteristics of the particular industry where the regulation is supposed to be applied.

can require instant and accurate operations in the Northwest to prevent a West Coast blackout.<sup>5</sup> Electricity is therefore probably better characterized as a “network product” instead — *i.e.*, it exists only as a function of the capacity and condition of the network itself.<sup>6</sup>

On the other hand, a telephone network obviously lacks any sunk “generation” facilities *per se* — the “generation” component in a telephone network is essentially the various parties to the telephone call. Thus, a telephone network is essentially a large distribution network. Moreover, because the telephone network is specifically designed to route individual telephone calls to specific termination points, there may, in fact, be one or more demarcation points along the route of a call — *i.e.*, a switch. Ideally, if the 1996 Act successfully creates tangible, facilities-based competition for telecommunications services and products, then there should really be only one true “bottleneck” facility — *i.e.* the point(s) where all of the carriers must interconnect their networks. On the “trunk” side of the switch, supply of interstate transmission — in the form of both carriers and excess capacity available for purchase — is currently highly elastic, with more capacity constantly being built. On the “line” side of the switch, hopefully — if the pro-entry provisions of the 1996 Act succeed — there will be various facilities-based alternatives to the traditional copper loop in the form of fixed-wireless, mobile wireless, cable, utility, or other distribution methods. Accordingly, assuming the telecommunications industry has resolved all of the generic pricing and access issues and, therefore, the interconnection point is really the last true “bottleneck” in the network, then we should simply place all of the various firms’ switches into consolidated “co-location office parks” and regulate these facilities accordingly to prevent any strategic, anticompetitive behavior.<sup>7</sup>

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<sup>5</sup> Jerry A. Sturdivant, Power Deregulation is the Road to Ruin, *THE COLOMBIAN* (July 24, 1997) (Op-Ed Section).

<sup>6</sup> Indeed, in a true commodity market, a purchaser actually buys a tangible product. Thus, after a commodity is purchased, the buyer must be able to either immediately resell the commodity, or have some specific place arranged to hold the commodity before it can be used or resold. If the purchaser neglects to arrange a storage destination for the commodity, however, then (as actually happened to my good friend’s grandfather) the buyer may get an unexpected phone call in the middle of the night to come pick up two loads of pork bellies from the yard. Yet, unless we are all suddenly supposed to be bound by the laws of Sir Fig Newton, rather than his brilliant and apple-loving brother Sir Isaac, it is quite unclear how one is supposed to pick up a truckload of raw bulk power.

<sup>7</sup> See Lawrence J. Spiwak, Reconciliation of Telecommunications Markets After the 1996 Act: Implications for Long-Term Market Performance, *ANITRUST REPORT* (May 1997) (hereinafter “Market Reconciliation”) at 20.

Given these network properties, Congress deliberately decided to regulate the telecommunications and electric utility industries in very different ways. Specifically, electric utilities, unlike telephone companies, are *not* common carriers. In other words, telecommunications service providers must, as common carriers, take all comers onto their networks on a non-discriminatory, *pro rata* basis. On the other hand, because system reliability is clearly an important social goal, Congress specifically declined to make electric utilities common carriers — *i.e.*, they *need not* let all comers use their networks on a non-discriminatory basis. Rather, in order to maintain system reliability, the owners of the constrained facilities may give themselves priority over other would-be users of the network.<sup>8</sup> Congress had the opportunity to reclassify electric utilities as common carriers when it passed the Energy Policy Act of 1992, but again specifically declined to do so.<sup>9</sup>

The importance of a public policy that ensures constant electric utility system reliability cannot be understated. To help place this regulatory dichotomy into modern context for educational purposes, perhaps the best way to explain this policy choice is to state the proposition bluntly — *i.e.*, if the phones go out, it will admittedly create a major public inconvenience; however, if the electricity goes out, please remember New York City, 1977. Notwithstanding the possibility of social anarchy, however, as we now live in an era where it is perfectly acceptable to “move beyond” accepted principles of the laws of both economics and physics, it appears dangerously that this seemingly “minor” societal detail will not deter the Clinton Administration’s

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<sup>8</sup> See *City of Anaheim v. Southern California Edison Co.*, 955 F.2d 1373, 1380-81 (9th Cir. 1994). There, the court refused to find a utility’s refusal to let a rival use a constrained power line to be a violation Section 2 of the Sherman Act, because the utility had a limited amount of capacity on the line and it desired to use that capacity to the limit when it could obtain inexpensive power. According to the court, when the utility can obtain less expensive inputs from the production market (*i.e.*, cheap power) these savings can be rolled into its other costs and result[ ] in . . . savings to all of its customers. In this sort of regulated industry, it is certainly to the benefit of the monopolist’s customers if its rates are as low as possible. Indeed, that is the major reason for the existence of regulatory commissions. . . . In other words, the public interest is well served when that happens, and that gives even more weight to the propriety of the refusal.

As such, the court found the plaintiff’s argument that a monopolist has “a duty to deal based on the extent to which a competitor might benefit if it had unlimited access to the monopolist’s facility,” rather than a “duty to deal based on the harm that would result to competition from the monopolist’s refusal,” improperly turns “the essential facilities doctrine on its head.” See also *City of Vernon v. Southern California Edison Co.*, 955 F.2d 1361 (9th Cir.), cert. denied, 506 U.S. 908 (1992).

<sup>9</sup> See, e.g., Federal Power Act Sections 211-212, 16 U.S.C. §§ 824j-824k.

desire to sacrifice reliability in favor of yet another opportunity to reallocate (and then later reappropriate) improperly wealth.<sup>10</sup> Indeed, rather than formulate the most efficient way to allocate resources after conducting a detailed economic analysis of the U.S. electric utility industry, the Clinton Administration's recent "Comprehensive Electricity Competition Plan" simply asks Congress to fix whatever legal and economic infirmities may have occurred previously to advance their agenda.<sup>11</sup> Unfortunately, attempting to have Congress wave a magic wand will overcome neither the laws of physics nor the laws of economics, and will very probably have substantial adverse affects on overall consumer welfare instead.<sup>12</sup>

Congress's deliberate choice not to classify utilities as common carriers raises one more important legal point: because Congress deliberately decided not to classify utilities as "common carriers," under well-established legal precedent dating back to the Supreme Court's decision in *Otter Tail*,<sup>13</sup> FERC may not *sua sponte* compel utilities to "wheel" power (*i.e.*, transmit power through their networks) to other utilities just because FERC thinks that is a better idea.<sup>14</sup> Despite this precedent and the plain language of the 1992 Energy

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<sup>10</sup> See The Search for Meaning at 10 (Briefly explaining how current FERC policies believe erroneously that it is possible to have "competition without change.")

<sup>11</sup> See Clinton Administration Comprehensive Electricity Competition Plan (rel. March 25, 1998) at Section V (Amending Existing Federal Statutes to Clarify Federal and State Authority).

<sup>12</sup> Cf. George C. Loehr, Ten Myths About Electric Deregulation: Electrons Seem Imaginary, but Reliability is Real, PUBLIC UTILITIES FORTNIGHTLY (April 15, 1996) at 28.

<sup>13</sup> *Otter Tail Power Company v. U.S.*, 410 U.S. 366, 375-76 (1973) ("Otter Tail"). There, the Court expressly held that:

So far as wheeling is concerned, there is no authority granted the Commission under Part II of the Federal Power Act to order it, for the bills originally introduced contained common carrier provisions which were deleted. The Act as passed contained only the interconnection provision set forth in § 202(b). The common carrier provision in the original bill and power to direct wheeling were left to the "voluntary coordination of electric facilities."

<sup>14</sup> Indeed, even when FERC may exercise its narrow wheeling authority Sections 211 and 212 of the FPA, it may only do so upon request. Moreover, before FERC may issue any order compelling one utility to involuntarily wheel power for another, FERC must not only first find that such *sua sponte* wheeling: "is in the public interest" and would either (A) "conserve a significant amount of energy"; (B) significantly promote the efficient use of facilities and resources"; or (C) "improve the reliability of any electric utility system" to which FERC's wheeling order applies, but FERC must also find that its wheeling order:

- (1) is not likely to result in reasonably ascertainable uncompensated economic loss of any electric utility, qualifying cogenerator, or qualifying small power producer, as the case may be, affected by the order;

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Policy Act,<sup>15</sup> FERC is currently trying to turn utilities into *de facto* “common carriers” via certain rate-making provisions under the Federal Power Act<sup>16</sup> and,

- (2) will not place an undue burden on an electric utility, qualifying cogenerator, or qualifying small power producer, as the case may be, affected by the order;
- (3) will not unreasonably impair the reliability of any electric utility affected by the order; and
- (4) will not impair the ability of any electric utility affected by the order to render adequate service to its customers.

Tragically, as discussed *passim*, the empirical evidence clearly demonstrates that FERC has blatantly disregarded these Congressional directives. Maybe its just me, but it seems to be just a bit presumptuous on FERC’s part that it believes legitimately that it can *sua sponte* stretch the FPA’s prohibition against “unduly discriminatory or preferential” rates, charges services or facilities to such an absurd point as to render FPA Sections 211 and 212 — the specific and only wheeling provisions contained in the FPA — absolutely meaningless. I’m sorry, but it is black letter law that an administrative agency may neither “subvert the public interest . . . to the interest of ‘equalizing the playing field among competitors.’” See, e.g., *SBC Communications, Inc. v. FCC*, 56 F.2d 1484, 1491 (D.C. Cir. 1995); *Hawaiian Telephone v. FCC*, 498 F.2d 771, 775-76 (D.C. Cir. 1974) (a legal and economic analysis of competitive issues under the public interest standard must be more than an inquiry into “whether the balance of equities and opportunities among competing carriers suggests a change.”); *W.U. Telephone Co. v. FCC*, 655 F.2d 1112, 1122 (D.C. Cir. 1981) (“equalization of competition is not itself a sufficient basis for Commission action”) nor adopt an interpretation of a statute that “goes beyond the meaning that the statute can bear. . . .” See also, *MCI Telecommunications Corp. v. AT&T*, 512 U.S. 218, 226 (1994); *Chevron U.S.A. Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 842-43 (1984); *Southwestern Bell Corp. v. FCC*, 43 F.3d 1515 (D.C. Cir. 1995). Considering the that FERC’s authority to order wheeling — i.e., increased transmission access — under FPA Section 205 as an antitrust remedy is “questionable” at best, see, e.g., *Otter Tail*, *supra* n. 13; *Florida Power & Light Company v. FERC*, 660 F.2d 668, 677 (5th Cir. 1981), cert. denied, 459 U.S. 1156 (1983); *Richmond Power & Light v. FERC*, 574 F.2d 610 (D.C. Cir. 1978); *Central Iowa Power Cooperative v. FERC*, 606 F.2d 1156 (D.C. Cir. 1979) (FPA prohibited FERC was prohibited from ordering power pool participants to wheel under Sections 205 and 206 because the tariff was voluntary), subverting the public interest to level the playing field among competitors certainly is not a compelling justification. See e.g., *Richmond Power & Light v. FERC*, 574 F.2d 610, 621 at n.43. (D.C. Cir. 1978), wherein the court stated that it was “not entirely pleased with the Commission’s discussion of the economic principles operable in this situation.” In particular, the court admonished FERC because “the Commission [had] stumbled down the trail it had chosen” and could have instead traveled “a smoother road if it would lay out the competing principles of ratemaking, explain why it accepts particular theories and rejects others, and then elucidate how the principles adopted support the specific allocation of costs. Such an explanation would not only aid our review but, we believe, would lead to better informed and better reasoned decisions by the agency itself.”

<sup>15</sup> *Id.*

<sup>16</sup> It is very important to note that courts have found that simply because a tariff may be “unduly preferential or discriminatory” does not automatically mean that the tariff may be, in fact, “anticompetitive.” See generally, *Central Iowa*, *supra* n. 14. “Undue discrimination” concerns the specific issue of whether different rates terms or conditions are being charged or  
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with this paradigm, gain the ability to mandate utilities to wheel power to other utility monopolies.<sup>17</sup> As discussed more fully below, the adverse consequences on market performance and consumer welfare caused by FERC's blatant disregard of these important legal, economic and structural realities are becoming increasingly apparent.

Second, because both telecommunications providers and electric utilities provide a "public utility service," both telecommunications carriers and utilities have a statutory obligation to provide reliable service at just and reasonable rates. Given our society's complete and total reliance on electricity, however, a utility's obligation to provide reliable service at just and reasonable rates takes

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imposed for the same service. See, e.g., *Kansas Cities v. FERC*, 723 F.2d 82, 94-95 (D.C. Cir. 1983) (To prescribe rates that are known to be unduly discriminatory or preferential is to prescribe rates that are known to be unlawful). Undue discrimination has a very broad standard because these allegations may arise from factors wholly unrelated to competitive issues. See generally, *Boroughs of Ellwood City v. FERC*, 731 F.2d 959, 978 (D.C. Cir. 1984). In contrast, complainants have a higher burden to prove that a proposed tariff is "anticompetitive", because "anticompetitive" focuses on injury to the overall competitive process and not injury to one specific competitor. See e.g., *Brunswick Corporation v. Pueblo Bowl-O-Mat*, 429 U.S. 477, 487-89 (1977). As Now-Justice Breyer explained in *Town of Concord v. Boston Edison Company*, 915 F.2d 17, 21-22 (1st Cir. 1990), cert. denied, 499 U.S. 931 (1991) (*Town of Concord*):

[A] practice is not "anticompetitive" simply because it harms competitors. After all, almost all business activity, desirable and undesirable alike, seeks to advance a firm's fortunes at the expense of its competitors. Rather, a practice is "anticompetitive" only if it harms the competitive process. It harms that process when it obstructs achievement of competitions basic goals — lower prices, better products, and more efficient production methods.

Indeed, other courts have recognized that a firm's desire to crush its competitors is not necessarily "anticompetitive," because this is exactly what competing firms are supposed to do. See e.g., *Ocean State Physicians Health Plan, Inc. v. Blue Cross and Blue Shield of Rhode Island*, 883 F.2d 1101, 1113 (1st Cir. 1989), cert. denied, 494 U.S. 1027 (1990); *Olympia Equipment leasing Company v. Western Telegraph Company*, 797 F.2d 370, 379 (7th Cir. 1986), cert. denied, 480 U.S. 934 (1987).

<sup>17</sup> Not that FERC cares, but such action is clearly against the law. For example, in *New York State Electric & Gas Corporation v. FERC*, 638 F.2d 388, 403 (2d Cir. 1980), cert. denied, 454 U.S. 821 (1981), NYSEG sought review of certain Commission orders modifying certain contracts on the grounds that the provisions contained therein violated federal antitrust policy. The Second Circuit reversed and remanded, holding that if:

the Commission determines that a particular rate, charge, or condition is unreasonable, it can order a modification. But where, as here, the modification amounts to an order requiring wheeling, it must be preceded also by determinations in accordance with [FPA] §§ 212 and 212. Simply put, we will not allow the Commission to do indirectly without compliance with statutory prerequisites, what it could not do directly without such compliance.

on a very special significance.<sup>18</sup> In particular, utilities have a rather complex and amorphous legal (and, perhaps more accurately, a political) “obligation to serve” their “native load.”<sup>19</sup> This “native load” includes both retail customers as well as “full-requirement” wholesale customers.<sup>20</sup>

Basically, a utility’s “obligation to serve” boils down to two primary functions: (1) ensure reliability (*i.e.*, ensure that the juice doesn’t stop following); and (2) ensure that its native load customers always receive, to the extent practicable, the lowest cost power available. In order to fulfil this obligation to serve, utilities either have to construct enough generation and transmission facilities to meet their native demand or purchase other, cheaper, capacity if available. Any purchases of bulk power or investments into new plant are then reviewed by the states and FERC to determine whether the utility “prudently” incurred these costs.<sup>21</sup>

This residual obligation to serve is one of several primary impediments to the creation of a truly “rivalrous” electric utility industry. As stated above, electricity is not a commodity, but is instead a network product (*i.e.*, it follows the path of least resistance). In other words, much like ranchers’ problems with feral animals, a utility cannot, in effect, erect a fence to keep other people’s electrons off of their grids.<sup>22</sup> Thus, it is quite unclear how FERC expects a “workably competitive” market to emerge when incumbents are required to “compete” by sharing their already constrained transmission facilities with “rivals” which may freely enter and exit the market as they please<sup>23</sup> yet, at the same time, incumbents are prohibited from exiting the

<sup>18</sup> See supra n. 10 and text above.

<sup>19</sup> In other words, whenever a major power black-out occurs, one of the first calls a utility CEO usually gets is from the governor or mayor demanding why their constituents are being deprived of their American birthright of affordable and reliable electricity.

<sup>20</sup> As explained more fully below, these wholesale requirement customers are generally municipal or cooperative utilities or large industrial customers located within a utility’s service network.

<sup>21</sup> Note: Given the geographic locations and load characteristics of most utilities, generation requirements are often met with a combination of both internal generation and imported power.

<sup>22</sup> However, as discussed *infra*, when two recent blackouts wiped out the entire West Coast, feral animals provided a rather convenient initial excuse. The blame was subsequently shifted on to trees.

<sup>23</sup> See, e.g., Editorial: What Competition?, *THE FRESNO BEE* (May 24, 1998) at B4; Nationwide Bid to Sell Power Fails, *OMAHA WORLD-HERALD* (April 29, 1998) at 22; Matthew C. Quinn, Enron Halts Efforts in California, *THE ATLANTA JOURNAL/CONSTITUTION* (April 23, 1998) at F02.

market if they choose — *i.e.*, incumbent firms, despite the economic costs, must always ensure network reliability, even if it means serving as a “carrier of last resort” for inefficient rivals. In other words, the failed notion of “competition without change.”<sup>24</sup>

A third distinction between the telecommunications and electric utility industries is that while both industries are highly capital intensive, the costs associated with constructing generation (and especially transmission) capacity are nonetheless very different from the costs associated with constructing telecommunications networks. For example, the construction of power plants and bulk power transmission facilities require the investment of far greater substantial sunk costs (both endogenous and exogenous) than those costs required to build a telephone network. The majority of utilities’ fixed costs, once sunk, clearly cannot be costlessly re-deployed for another purpose (indeed, while you obviously can’t move a nuclear power plant, you can move a switch). Moreover, because of the high sunk costs associated with the construction of additional utility capacity, the overall capacity of new utility facilities are typically based on fifteen to thirty-year load forecasts (*i.e.*, demand eventually grows large enough to require total design capacity). Finally, in addition to the actual costs of investment, there are other economic costs associated with the construction of a new generation or transmission facilities, not the least of which include the ability to obtain favorable financing, satisfying comprehensive environmental requirements before a site can even be selected and, of course, over-coming local objections to construction (the “Not In My Back Yard” or “NIMBY” syndrome).<sup>25</sup>

Fourth, electricity and telecommunications products and services are sold and marketed in very different ways.<sup>26</sup> In telecommunications, while the basic product/service is the simple ability to place a telephone call from one point to another, there is, in fact, a tremendous amount of product and price differentiation for different services. For example, there are a variety of discrete telecommunications services (at different prices), such as business, residential, international, toll and wholesales service, such as access and transport. Although from a supply-side perspective, many of the facilities used

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<sup>24</sup> See The Search for Meaning, *supra* n. 2 at 14.

<sup>25</sup> See Steve Hoffman, Enhancing Power Grid Reliability, EPRI JOURNAL (Nov. 21, 1996) (“No one wants new construction in their backyard, a problem that affects the construction of power delivery equipment but also of freeways, dams and airports. . . .”)

<sup>26</sup> Of course — given the Clinton Administration’s recent statement that electricity can be labeled, marketed and sold in the same manner as nutritional dietary supplements — I could be wrong. See Clinton Administration Plan, *supra* n. 11 at Section II.A.

to provide various services are identical, from a demand-side perspective, consumers generally do not view each discrete service as acceptable substitutes for the another. Moreover, the wide variety of pricing plans, in addition to switching costs, also indicates that there is substantial product differentiation among telecommunications services.<sup>27</sup> A demand-side approach is also important if the relevant geographic markets are to be defined accurately — *i.e.*, a customer does not really care what services may be available in other state or region. Rather, the relevant market is really the distance between the end of your hand to the telephone itself.

In the electric utility industry, there are arguably two separate product markets: generation and transmission. Just as in telecommunications, there is substantial product differentiation for both products. Similar to the telecommunications situation, while the underlying facilities may be identical from a supply-side perspective, however, from a *demand-side* perspective, both generation and transmission are purchased either as “firm” (*i.e.*, long-term) capacity or as “interruptible” (*i.e.*, short-term) capacity.<sup>28</sup> Yet, common sense dictates that generation without transmission — or transmission without generation — means absolutely nothing to a potential purchaser. Thus, contrary to current popular belief (*e.g.* FERC’s) that generation and transmission should be viewed as discrete, unbundled products, because utility dispatchers think of generation and transmission as a *bundled product*, then economic analysis should therefore view them this way as well.<sup>29</sup> I describe

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<sup>27</sup> See Lawrence J. Spiwak, What Hath Congress Wrought? Reorienting Economic Analysis of Telecommunications Markets After the 1996 Act, 11 ANTI-TRUST MAGAZINE 32 (Spring 1997) (hereinafter “Reorienting Economic Analysis”) at 33.

<sup>28</sup> It is also important to recognize that all generation capacity is not homogeneous. For example, nuclear power (while extremely expensive to build and de-commission) is generally valued as the cheapest power on a per/unit basis. Nuclear is generally followed by hydro-electricity, which is very plentiful in the Pacific Northwest and in Eastern Canada. Next comes coal- and gas-fired plants. At the bottom of the list are diesel- or oil-fired plants, which are the most inefficient and expensive plants to run. Finally, if existing capacity is insufficient to serve the load, then utilities must buy power on the open market. Unfortunately, despite Congressional efforts to revitalize the U.S. nuclear power industry in the 1992 Energy Policy Act, given the huge sunk costs (and financial risks) associated with the construction of nuclear power facilities, the U.S. nuclear industry is basically dead.

<sup>29</sup> A classic case of how people misunderstand how an electricity on a utility network is dispatched and priced can be found in the D.C. Circuit’s seminal case of *Cajun Electric Power Cooperative, Inc. v. FERC*, 28 F.3d 173 (D.C. Cir. 1994). There, the D.C. Circuit rejected FERC’s decision to permit a utility to recover its stranded investment costs from certain competitors who use its transmission services. According to the court, this provision was, in essence, nothing more than a tying arrangement and, as such, concluded that if a company can charge a former customer for the fixed cost of its product whether or not the customer wants that product, and can  
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this bundled product as “delivered bulk power.” That is to say, depending on a utility’s immediate load requirements, existing in-house capacity and current market conditions, each utility must constantly undertake a series of inquiries as to whether, for example, expensive firm power with cheap interruptible transmission is more valuable than expensive firm transmission with cheap interruptible power, or any other conceivable combination thereof, *at the time the power is actually needed to serve their load*. Thus, the only way to develop a realistic paradigm that promotes, rather than deters, competition in the electric utility industry is to recognize the actual products bought and sold — *i.e.*, “delivered bulk power.”<sup>30</sup>

Indeed, even though the costs of generation (because of more efficient technology and relative ease of entry into the generation market) have generally declined over the past several years, cheap power — as mentioned

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tie this cost to the delivery of a bottleneck monopoly product that the customer must purchase, the products are as effectively tied as they would be in a traditional tying arrangement. To illustrate its point, the court set forth the following analogy:

[S]uppose a certain Company A both owned the roads and sold cars. Section 9a of the [tariff] is equivalent to a rule whereby former car customers of Company A, who decide instead to purchase a car from Company B, must pay a toll for road use that covers not only the cost of the road, but also the cost of the displaced productive capacity that would have built the cars they no longer buy from Company A. At any rate, it is hard to imagine that such limited and costly access to the “roads” — that is, to [the utility’s] transmission grid — will serve to effectively mitigate its market power, especially in the context of electricity generation where fractions of a cent per kilowatt hour can make the difference among competitors. 28 F.3d at 178.

The problem, however, is that the court got it all wrong. The issue of “stranded costs” does not involve a situation where products and services are fungible (*i.e.*, if one customer breaks a contract, I can sell the same unit to another customer). Quite to the contrary, power plants — which are built with specific load profiles in mind — are the very definition of “sunk costs” — *i.e.*, costs, once sunk, that cannot be costlessly redeployed for another use. Thus, the better analogy should be to the situation where: (a) customers request Company A to build cars to extremely exacting specifications (special engine, stereo, upholstery, wheels, paint job, etc.) to meet the specific terrain where they live; (b) the customers demand these cars, but refuse to put any money down; (c) due to political pressure Company A must still sink the substantial costs necessary to construct a special plant that can accommodate these unique orders (in fact politicians promise Company A’s managers: “Don’t worry, we’ll get your money, plus a reasonable return on investment, back for you”); yet (d) after the costs are sunk and the cars are built, customers decide subsequently that they don’t want the special cars after all — leaving Company A holding the bag. As stated *infra*, this is not a “tying case” — only one of “network externalities.”

<sup>30</sup> Cf. *Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961) (economic analysis must recognize both “the market area in which the seller operates” and how the “purchaser can practicably turn for supplies”).

above — means absolutely nothing without the ability to transmit the power to those who need it. Thus, the big (and clearly unaddressed) problem in the electric utility industry today is how to expand an already constrained transmission network. Unfortunately, while it appears that FERC has taken a rather dynamic view about the generation market, it also appears that FERC has taken a rather static view of the transmission market — *i.e.*, that the state of transmission capacity is given and unchanging. More disturbing, however, is the fact that the empirical evidence demonstrates that Order No. 888 and its progeny have done nothing to create any incentive — indeed, it is actually a *disincentive* — to build any additional transmission capacity (either from incumbents or new entrants). As with all issues regarding valuable yet constrained facilities, the key disputes always come down to two points: pricing and access.

*Pricing:* In general, FERC permits utilities to recover only the embedded (rather than the incremental, forward-looking) cost of transmission facilities. FERC officials publicly justify this paradigm as the “regulatory golden rule: do unto others as you would do unto you” — *i.e.*, provide rivals transmission at the same price a utility would charge itself for such capacity. However, because transmission capacity is already highly constrained — and therefore any mandatory requirement to release capacity to a competitor may actually impede the ability of the owner of such facility to transmit enough power to serve its own load — limiting recovery to embedded costs acts as a direct disincentive for firms to invest any additional high sunk costs (and to incur the inherent risks associated with such an investment) necessary to construct additional facilities.

*Access:* FERC’s paradigm is essentially designed to let one exclusive monopolist purchase power from a variety of generation sources, but then basically “free ride” off of another monopolist’s constrained transmission system — even though the latter needs all the transmission capacity available to serve its native load.<sup>31</sup> This free-rider problem is now exacerbated by the introduction of non-utility “power marketers” which, by definition, add no new capacity to the market and simply increase the economic costs of delivering power to the consumer.<sup>32</sup> As such, the concept of, and now primary

<sup>31</sup> See *supra* n. 8.

<sup>32</sup> See, e.g., *Enova Corporation & Pacific Enterprises*, 79 FERC (CCH) ¶ 61,107 (1997); *Morgan Stanley Capital Group Inc.*, 79 FERC (CCH) ¶ 61,109 (1997); see also Agis Salpukas, *California’s Effort to Promote Plan For Electricity Is Off to a Slow Start*, *New York Times* (Feb. 26, 1998) at D1, D6 (reporting that because of “hard-sell techniques or even outright fraud,” California regulators had to suspend the licenses of dozens of non-utility marketers.)

reliance upon, energy brokering/marketing programs as a means of bringing “more” competitors to a distribution system characterized by *static* (i.e., unchanging) capacity does absolutely nothing to improve either consumer welfare or a regulated firm’s bottom line. Instead, this policy of “neo-competition” succeeds only in reallocating wealth from one firm to another, unduly burdening an already constrained national transmission grid (hence the recent proliferation of rolling blackouts), and providing public policy officials with yet another press release to enhance their political narcissism.

To place this debate into context, it is important to understand that owners of transmission facilities traditionally would generally agree to wheel power on a “point-to-point” basis — i.e., from the generation facility directly to the purchaser’s substation. However, over the past several years, FERC, at the urging of industrial customers and munis, has moved towards a “network service” regime (which, unfortunately, arose from a misconception of how a telephone network operates). “Network” service — unlike “point-to-point” service — basically permits one or more rivals to dictate how the actual owner of the network operates and dispatches its network.<sup>33</sup> Because of all of the difficult elements (i.e., loop flow, spinning reserve, line loss, etc.) inherent to a functioning grid (remember, energy follows the path of least resistance), allowing multiple rivals — who are often geographically separated and therefore have very different demand and cost characteristics — to *de facto* dispatch another’s system has a direct effect on optimal system efficiency and reliability.<sup>34</sup>

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<sup>33</sup> The usual counter argument is that, with the presence of “Independent System Operators” or “ISOs,” distortions resulting from “network” dispatch should be de minimis. Unfortunately, because the ISOs currently proposed are basically limited to each utility’s individual service territory (i.e., an “ISO of One”), it is unlikely that current ISO proposals will contribute to optimal dispatch. The problem is that, as discussed supra, Order No. 888 statically believes that it can impose a “common carrier” model on the existing grid without providing any incentive to expand the overall capability of this grid. Because this grid was specifically designed to operate efficiently under the pre-Order No. 888 regime, the most optimal use of the network would be to dispatch the generation which is closest to the load and not to serve as a giant faux “commodities” trading floor. By mandating that each utility essentially act as an “ISO of One,” therefore, FERC forces a utility to operate its network in an inefficient manner (which, not uncoincidentally, ends up harming consumers). Yet, if an ISO can take advantage the substantial economies of scale and scope by dispatching multiple utilities, then the chance of inefficient network dispatch should correspondingly decrease. Cf. Reiner Lock, Power Pools & ISO’s: Monitoring Market Power in a Restructured Industry, PUBLIC UTILITIES FORTNIGHTLY (March 1, 1988) at 26.

<sup>34</sup> The usual industry analogy to help neophytes understand the consequences of “network” service is to imagine that you are the manager of the Waldorf Astoria. One day, the manager of the neighboring hotel walks in and requests to reserve all of the Waldorf’s rooms, (continued ...)

Accordingly, whether intentional or not, given FERC's policies summarized above, the only conclusion that one can reach is that FERC has essentially assumed that electric utility industry restructuring is best achieved by a perpetual "resale" model, rather than by encouraging tangible, facilities-based entry. Yet, because a number of economic factors make a strict resale model simply unsustainable over a significant period of time, it is therefore highly doubtful that such an approach could contribute anything positive to overall consumer welfare.<sup>35</sup> To wit, from a public-policy point of view, so long as demand continues to increase, then there is really no such thing (just as being "too rich" or "too thin") as having enough excess (*i.e.*, elastic) capacity. This is because if capacity is in short supply (*i.e.*, constrained), then the owner of the constrained facility will likely have the incentive to engage in some kind of strategic, anticompetitive conduct against other potential new entrants in order to protect its sunk investment. On the other hand, if supply is elastic (*i.e.*, it is very easy to obtain capacity from other sources), then the owner of the facility will instead have the incentive to *compete* in order to ensure full utilization of its facilities.<sup>36</sup>

Indeed, despite the fact that FERC officials love to proclaim that if the government could break up the old AT&T, it should *a fortiori* be just as easy to "break-up" utility monopolies, the reality is that FERC's strict resale approach

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every night, for an indefinite period of time. Moreover, the rival informs you that he really doesn't want to pay a reservation fee for taking up the entire hotel and, moreover, will become very upset if the Waldorf attempts to reserve any rooms for any other customer. Appropriately viewing this request as over-broad, the you ask how many rooms this person really needs, and for what specific times. "Well," responds the rival, "I really don't know. However, I want you to put your business on hold just in case I need the capacity." Stunned, you reply to the rival, "If you need the excess capacity, why don't you just go out, find a nice piece of property, get the financing, and build your own excess capacity." "Nope," says the rival, "that is simply far too risky and far too expensive. I would rather just have yours."

<sup>35</sup> Once again to help neophytes conceptualize the consequences of a strict "resale" approach, pretend that you are about to throw a party, and you need quite of bit of ice for your guests. For some reason, the only available source for ice is your freezer. In this freezer, you have one of those old metal ice trays, with what looks like an extended tic-tack-toe game or grid with a handle attached to it to help form individual cubes. The problem, however, is that regardless of whether you decide to use the tray with or without the separator, under the laws of physics (and, *a fortiori*, the laws of economics,) the total volume of the tray will still only produce a certain amount of ice for your guests — even though more people show up to the party than originally expected and the liquor store only had warm beer for sale. Moreover, by violently cracking the ice, one often ends up with numerous useless small shards of ice on the counter-top that melt before they can be used successfully — in other words, a dead-weight efficiency loss.

<sup>36</sup> See Reorienting Economic Analysis at 35.

is the exact polar opposite of the approach taken by the FCC at the time of divestiture. In contrast to the FERC approach, the FCC believed that the best and only way to achieve sustained rivalry for long-distance service was to encourage and to accelerate facilities-based entry — and not perpetual resale.<sup>37</sup>

By transforming the long-distance market from a market characterized by inelastic supply to a market characterized by tremendous excess supply, the FCC was eventually able to create today's robust long-distance market — which is currently characterized by, among other firms, at least *five* national facilities-based carriers — where consumers now enjoy sustained trends of declining prices and increased choices. Moreover, given such market performance, the costly asymmetrical, “dominant” carrier regulation of AT&T for domestic long-distance (and later, for similar reasons, international) service could therefore be eliminated.<sup>38</sup> One shudders to think how things might have turned out if the FCC had adopted a strict resale model (complete with some bastardized version of an ISO) of AT&T's then-existing network at the time of divestiture.

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<sup>37</sup> This approach was called the Competitive Carrier paradigm. See Policy & Rules Concerning Rates for Competitive Common Carrier Services and Facilities Authorizations Therefor, CC Docket No. 79-252 (“Competitive Carrier”), First Report & Order, 85 FCC 2d 1 (1980); Second Report & Order, 91 FCC 2d 59 (1982); recon. 93 FCC 2d 54 (1983); Third Report & Order, 48 Fed. Reg. 46,791 (1983); Fourth Report & Order, 95 FCC 2d 554 (1983), vacated, *AT&T v. FCC*, 978 F.2d 727 (1992), cert. denied, *MCI Telecommunications Corp. v. AT&T*, 113 S.Ct. 3020 (1993); Fifth Report & Order, 98 FCC 2d 1191 (1984); Sixth Report & Order, 99 FCC 2d 1020 (1985), rev'd, *MCI Telecommunications Corp. v. FCC*, 765 F.2d 1186 (D.C. Cir. 1985).

The idea behind the Competitive Carrier paradigm was relatively simple: AT&T, as the “dominant” carrier, would be subject to all existing regulations — i.e., rate of return and then later price cap regulation, all new tariffs would continue to be suspended for 45 days before any new rate could go into effect, numerous reporting requirements, and the like. However, in order to accelerate entry into the long-distance market (and therefore improve market performance to a level of sufficient rivalry such that regulation could eventually be removed altogether), the Commission basically removed all regulatory barriers to entry for new entrants. In addition, the Commission — via its 1980 MTS/WATS resale decision — helped new entrants, inter alia, to appear to consumers that they had a nation-wide facilities-based presence until networks could be completed. As a result of this paradigm, the long-distance market was transformed from a market characterized by a single dominant firm with a small competitive fringe, to a market characterized by highly elastic supply (both in capacity and in the number of competing firms), an extremely high churn rate, and a demonstrated trend of declining prices and increasing services. See Reorienting Economic Analysis at 35; Market Reconcentration at 19 & n. 8. Given these market conditions, the Commission eventually decided to remove the asymmetrical regulation previously imposed on AT&T, realizing that the economic harms created by asymmetrical dominant carrier regulation outweighed the public interest benefits the dominant carrier regulation was originally intended to achieve. See Motion of AT&T Corp. to be Reclassified as a Non-Dominant Carrier, Docket No. 95-427, 11 FCC Rcd 3271 (1995).

<sup>38</sup> See Reorienting Economic Analysis at 34-35.

It follows, therefore, that even if we assume *arguendo* that FERC's view that transmission and generation are really separate commodity markets is correct, then a utility must be permitted to operate its business as such. Yet, so long as a utility understands that FERC will require it to provide its "rivals" (*i.e.*, free-riders) with priority dispatch authority over its own requirements (*i.e.*, the aforementioned "network" service) at below market (*i.e.*, embedded cost) rates, then a utility will have absolutely no incentive to build any new capacity — even for its own internal needs.<sup>39</sup> If transmission capacity is priced correctly, however (*i.e.*, what the capacity is really worth in the open market), then firms (incumbents or new entrants) would have the incentive to build additional capacity to recover some of the short-term supra-competitive rents.<sup>40</sup> As such, by failing to correctly set a logical transmission pricing methodology, most observers expect the current shortage of transmission capacity only to get worse in the long-run.<sup>41</sup>

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<sup>39</sup> Indeed, given the hypothetical example in note 35 *supra*, it appears that FERC honestly believes it can reinvent the recipe for ice as well. Accordingly, it will be quite interesting to see how much "regulatory chutzpa" FERC and other public policy officials will extend to defend themselves as consumers begin to demand answers to the mounting empirical evidence demonstrating that Clinton Administration's flawed policies have actually hurt, rather than benefited, consumer welfare. See Kathryn Kranhold, *Electricity Trader's June Default Shows Vulnerability of Deregulation*, WALL STREET JOURNAL (July 9, 1998) ("The market turbulence, which raises questions about the newly deregulated electricity market and the trading of electricity, is starting to attract the attention of regulators around the country." Not only are Ohio and Indiana regulators starting investigations, but "in Washington, [FERC] has been asked to hold a conference on the price spikes and the wholesale electricity-trading market, and is considering what action to take.")

<sup>40</sup> Compare the case of the oil industry. After the various oil crises, the price of oil rose to supra-competitive prices. However, when other firms saw the long-term value of this market, they were willing to invest (and a fortiori willing to risk losing) the high sunk costs associated with such an investment that were necessary to find alternative supplies (e.g., North Sea oil drilling platforms). When excess capacity finally came on line in the mid-80's, prices dropped to under \$10/barrel. In the 1990's (barring the period of the Gulf War), the oil market has settled into a relatively stable equilibrium.

<sup>41</sup> See Peter Coy, *Utilities: Prognosis 1997*, BUSINESS WEEK, January 13, 1997 at 118; Sturdivant, *supra* n. 5 ("Construction spending for transmission systems is already down significantly. . . ."); Hoffman, *supra* n. 25, reporting that:

The limited construction of new transmission lines is one factor in the increased stress on the grid. Over the past decade, electrical loads have grown at an average annual rate of 2%. Yet in the same period, little new transmission capacity has been installed, largely because of the high cost of such lines (about \$1 million per mile for a 500 kV line) and the difficulty of obtaining new rights of way. \* \* \* \* The result is that the existing transmission system is being called upon to perform functions on a scale for which it was not originally designed.

This is not to say, however, that there is no merit to disaggregating vertically-integrated utilities if cheaper (*i.e.*, more efficient) generation sources are available. In this situation, the benefits of disaggregation clearly would exceed the benefits of vertical integration. Yet, despite the potential to achieve such efficiencies, it is highly unlikely that the current restructuring paradigm will ever permit consumers to realize and benefit from them. Because FERC continues to refuse to acknowledge the reality that the structural characteristics of the electric utility industry outlined above logically dictate viewing transmission and generation as a bundled product of “delivered bulk power,” it is impossible to talk seriously about any realistic areas where “unbundling” may be efficient.<sup>42</sup> Accordingly, as the restructuring of the electric utility industry process continues to careen down its course, such policies may end up duplicating the result of Value Jet’s unbundling experience rather than promoting good market performance.

Indeed, encouraging utilities to operate more efficiently seems to be the last thing on FERC’s mind. As explained more fully below, because regulation is supposed to be *a substitute for*, and *not a complement of*, competitive rivalry, both regulation (via direct pressure) and competition (via indirect pressure) are supposed to force firms to operate in a more efficient manner (whether they want to or not). In the former case, because regulators are supposed to set prices that accurately reflect costs, an integrated utility can squeeze independent distributors out of the market only if these distributors operate less efficiently, *i.e.*, at higher costs.<sup>43</sup> In the latter case, as market performance becomes increasingly rivalrous and consumers can easily switch among a number of acceptable substitutes, then firms will have to find ways to innovate and lower their costs if they want to survive in the market. If they do not, then they too will appropriately be forced to exit the market.

The problem in the electric utility industry, however, is that firms are not reacting to “competitive” pressures, but rather to government attempts to reallocate wealth by stringent and ubiquitous regulation. Indeed, rather than create a paradigm designed to create an underlying framework which is

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<sup>42</sup> Indeed, it is very important to remember that while the national grid is interconnected, its operational characteristics are not homogeneous. Thus, unlike the majority of the country, where generation is located relatively close to load — *i.e.*, generation comes from a wide variety of sources and is distributed over a large geographic area — there are several areas (mostly out west) where “unbundling” might be appropriate because generation is neither located even remotely near, nor is intended to serve, a particular utility’s load.

<sup>43</sup> See, e.g., *Town of Concord v. Boston Edison Co.*, 915 F.2d 17, 25-26 (1st Cir. 1990), cert. denied, 111 S.Ct. 1337, reh’g denied, 111 S.Ct. 2047 (1991) (*Town of Concord*).

conducive to sustained competitive rivalry (*i.e.*, promote market efficiency), the FERC model instead attempts to maximize *regulatory efficiency*.<sup>44</sup> As such, rather than making rational business decisions based on competitive pressures, utility strategic planners are forced to make “irrational” decisions to survive the regulatory regime *du jour*.<sup>45</sup>

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<sup>44</sup> I suppose this is one reason why FERC has let the rapid reconcentration of the electric utility industry go untouched (barring “voluntary conditions” designed to protect competitors, not competition, of course) — *i.e.*, the fewer firms there are in the market, then the easier it is to regulate them. See, e.g., Interview, FERC Chair James Hoecker; The Future of the Federal Energy Regulatory Commission, INFRASTRUCTURE (ABA Section of Public Utility, Communications and Transportation Law (Fall 1997)) at 1, 7 (“While we want to ensure that the markets are competitive . . . we have to make sure that mergers are not structured in a way that makes regulation less effective. Remember, it took DOJ a full year to decide what to do with the NYNEX/Bell Atlantic merger.”) Given the debacle of the U.S. government’s review of what most educated people would probably regard as an “unthinkable” merger, however, I don’t know how proud I would be to cite this case for support. See *Reconcentration of Telecommunications Markets After the 1996 Act: Implications for Long-Term Market Performance* (Second Edition), PHOENIX CENTER POLICY PAPER SERIES NO. 2 (July 1998).

<sup>45</sup> For example, as noted above, utilities will refuse neither to invest in new plant or infrastructure, nor even engage in preventative maintenance of existing facilities. See Sturdivant, *supra* n. 5, noting that maintenance is beginning to suffer, because “[r]ather than making periodic inspections as part of a maintenance program, many companies are already cutting crews and going to ‘breakdown maintenance,’ waiting for equipment to fail before working on it. To save overtime, they will wait till morning or wait till Monday to fix it.” For this reason, Order No. 888’s disincentive to build any new transmission capacity has also led utilities to engage in what I call the “Great Generation Swap.”

As mentioned *supra*, FERC apparently believes that with “open access,” consumers should be able to buy power from anywhere in the country and have this power wheeled directly to their doorstep. From an economic point of view, however, the most efficient way to dispatch a grid generally is to place the generation as close to the load as possible; if this structure is impractical, however, then utilities must constantly evaluate the benefits of purchasing and transmitting cheaper, distant generation versus the possible costs of not adequately serving their native load — *i.e.*, just because you can buy cheap hydropower in the Pacific Northwest and wheel that power to Key West, Florida doesn’t mean that this is still a good idea. Thus, assuming *arguendo* that restructuring actually produces a market structure that is conducive to competitive rivalry — *e.g.*, the ownership of generation and transmission facilities are completely unbundled (we are talking about some serious structural separation here), residual “obligations to serve”/“carrier of last resort” burdens are eliminated, and the supply curve for transmission capacity becomes elastic and shifts to the right, such that bottleneck concerns are alleviated — then a national “portfolio” of generation assets would make sense because the “marketer” will be able to meet demand anywhere in the country efficiently. Unfortunately, because existing policies provide no incentive to build any new transmission or generation capacity to get the competitive power to the people and “obligation to serve”/“carrier of last resort” responsibilities continue, current restructuring policies are simply providing utilities with the economically irrational incentive to “swap” both generation assets and loads with each other to

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Notwithstanding the distinctions outlined above, however, both the telecommunications and electric industries do share one important similarity — aside from ubiquitous regulatory oversight. Specifically, it is very important to recognize that “network externalities” play a key role in the performance of both the electric utility and telecommunications industries.<sup>46</sup> That is to say, in the context of a telephone network, consumers are generally better off if different individuals buy similar or compatible products. Because each user of a telephone network is strongly interested in having other users have compatible products, therefore, if network externalities are present, then these externalities may lend an advantage to a variant that just happens to attract a number of customers early.<sup>47</sup> Similarly, if a new firm seeks to enter the telecommunications or video market, without an established base of “committed” customers, it is unlikely that a new entrant could sufficiently sustain a “critical mass” of core customers to make the project economically viable.<sup>48</sup>

In the utility context, the more users a utility has on its grid, then the more the utility can spread the costs of maintaining the network among its customers — *i.e.*, the more customers on the grid, the lower the capacity charge per customer. However, if a large requirements customer decides to leave the system, then this customer’s prior contribution to the network will now have to be incurred or “shared” by the other users of the network. Such action can possibly create the feared “death spiral” — *i.e.*, if rates go up, perhaps other customers will elect to bolt from the network, again leaving the remaining users of the network to incur additional shared costs, which will then prompt

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minimize operational distortions on the national distribution grid just to provide politicians with the “appearance” of competition that politicians demand to observe.

<sup>46</sup> See generally, David Evans and Richard Schmalensee, *A Guide to the Antitrust Economics of Networks*, 10 *ANTITRUST* 36 (Spring 1996) at 38.

In one important respect, moreover, many network industries are like public utilities, with high fixed costs and low marginal costs. As a result, firms that price at marginal cost would not recover their fixed costs, which are often the costs of developing innovative new products and services. To survive, they have to price well in excess of marginal cost. And, since they are making a profit at the margin on almost every unit, they often engage in price discrimination. Volume discounts, special deals, and complex pricing systems are common.

<sup>47</sup> See Richard R. Nelson, *Recent Evolutionary Theorizing About Economic Change*, 33 *JOURNAL OF ECONOMIC LITERATURE* 48, 74 (1995).

<sup>48</sup> See James Olson & Lawrence J. Spiwak, *Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable Industry Market Performance?* 13 *CARDOZO ARTS & ENT. L. J.* 283, 285 (1995).

other consumers to leave the network, causing the remaining users' costs to rise, and so on.

### **III. Will the Restructuring Paradigms Currently Underway in the Telecommunications and Electric Utility Industries Really Lead to More Competition and De-Regulation?**

#### **A. Purpose of Regulation**

Before turning to more specific issues, perhaps an excellent preliminary step would be to examine the very purpose of economic regulation itself. The reason for doing so is rather obvious: the ubiquitous presence of regulation is probably the most significant structural factor affecting strategic business decisions in both the telecommunications and (in particular) the utility industry.<sup>49</sup> Indeed, utility strategic business decisions — unlike any other lawful business' decisions — are generally not efforts to capitalize on innovative business opportunities. Rather, utility business decisions are generally just valiant attempts to ride-out and survive the current regulatory

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<sup>49</sup> Indeed, the amount of regulation imposed on the utility industry is truly ubiquitous. On the federal side, FERC regulates all interstate transmissions and sales of wholesale electric energy by electric utilities under the Federal Power Act. See FPA § 201(b)(1), 16 U.S.C. § 824 (b)(1) (1988). Under the FPA, FERC has the authority to order interconnection, review utility mergers, regulate utilities' rates for interstate transmission and wholesale bulk power and, in limited circumstances, order a utility to wheel power for another utility. However, federal regulation of utilities does not end there. As discussed more fully below, depending on the mere form of a utility's of corporate structure, utilities may also be regulated by the Securities and Exchange Commission ("SEC") under the Public Utility Holding Company Act of 1935 ("PUHCA"). PUHCA is not designed to regulate the behavior (i.e., pricing and access) of the individual operating companies — that responsibility, as mentioned above, is left to the FERC under the FPA. Rather, PUHCA was designed to prevent financial abuse among public utility holding companies and their affiliates. See *Arcadia, Ohio v. Ohio Power*, 111 S. Ct. 415, 423 (1990) (Stevens, J. concurring) (citations omitted). On the local side, States regulate all of the "retail" aspects of utilities' businesses. This regulation includes, inter alia, the power to enforce exclusive local distribution franchises, the authority to require utilities to file separate rate filings for local service, the authority to require structural separation for utilities' regulated and non-regulated affiliates and, in particular, the authority to conduct prudence reviews regarding the size and scope of utilities' retail rate bases. As will be pointed out below, States' authority to determine exactly what facilities should be included in a utility's particular retail rate base gives States significant control over this utility's ability to utilize existing assets for telecommunications (i.e., unregulated) ventures. See, e.g., PUHCA Sections 34 (b), (i)-(m). Finally, if a utility seeks to enter the telecommunications industry, then it will, of course, be subject to applicable regulation by the FCC as well, depending on the type of service(s) it provides.

regime.<sup>50</sup> Accordingly, because the presence and degree of regulation is really inseparable from utility strategic business planning,<sup>51</sup> it is very important to touch on some basic economic and legal principles about the purpose of economic regulation.

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<sup>50</sup> As discussed throughout, the effect of the ubiquitous, copious and overly-intrusive regulation imposed upon the electric utility industry cannot be discounted when discussing utility strategic planning decisions. To wit, a utility may have at any one given time several rate cases pending before FERC or a state commission, and each one of these cases involve the appropriate allocation and recovery of sums that generally exceed several, if not hundreds, of million of dollars. Given the huge amount of money at stake, utilities are therefore continuously forced into a regulatory “Faustian” dilemma — i.e., do the potential benefits of aggressively challenging its regulator’s flawed long-term policy proposals in one proceeding outweigh the risk of angering its regulators and losing its rate cases today? Tragically, considering today’s volatile stock market and current regulatory uncertainty, I have often seen (nor can I really blame them) utilities choosing to protect existing capital in favor of influencing long-term industry structure (see, e.g., the industry’s experience with “voluntary” open-access and the (unfulfilled) promise of stranded cost recovery.) However, this is clearly not the way either public policy nor business decisions should be carried out. See *The Search for Meaning*, supra n. 2. Indeed, as Judge Frank Easterbrook observed well over ten years ago,

Often an agency with the power to deny an application (say, a request to commence service) or to delay the grant of the application will grant approval only if the regulated firm agrees to conditions. The agency may use this power to obtain adherence to rules that it could not require by invoking statutory authority. The conditioning power is limited, of course, by private responses to the ultimatums — firms will not agree to conditions more onerous than the losses they would suffer from the agency’s pursuit of the options expressly granted by the statute. The firm will accept the options expressly granted by the statute. The firm will accept the conditions only when they make both it and the agency (representing the public or some other constituency) better off. Still, though, the agency’s options often are potent, and the grant of an application on condition may greatly increase the span of the agency’s control.

Frank Easterbrook, *The Court and the Economic System*, 98 HARV. L. REV. 4, 39 (1984) (emphasis supplied).

<sup>51</sup> Again, take for example the following hypothetical. The FCC plans to auction a block of valuable spectrum. A utility learns of this auction, and decides it would like to make a bid. The other bidders in the auction come from a wide variety of other industries, but not from the utility industry. The utility bids \$500 million and wins the auction. Rather than being able to enjoy its victory like a regular “unregulated” business, however, its regulators will no doubt be on the phone very soon thereafter demanding to know where the utility received the money from to invest such a substantial sum of capital outside of its core business. If the utility replies that it was using cash reserves from profits, as discussed below, the regulator will probably nonetheless demand to know why the utility did not re-invest its money into its core business. On the other hand, if the utility informs its regulators that it intends to borrow the money, then the regulators will scream that this debt better not raise the cost of capital — and therefore the rates — for the utility’s captive ratepayers.

Believe it or not, there is really a purpose to regulation — unfortunately, everyone appears to have either forgotten it or deliberately ignored it. As stated *supra*, the core of this theory is quite straightforward — *i.e.*, that economic regulation is supposed to be a *substitute for*, and *not a complement of*, competitive rivalry. It is *not* — contrary to popular belief — “*because we can*.”<sup>52</sup>

Moreover, many people fail to understand that while appropriately tailored regulation can produce certain benefits for consumers, regulation — by its very definition — also imposes significant economic costs on society, no matter how innocuous, *de minimis*, or well-meaning the regulation is intended to be. These economic costs include compliance costs on those firms subject to such regulation, the possible deterrence or delay of innovation, the creation of market structures which can promote collusive behavior and, as discussed in more detail below, the often denied, yet highly ubiquitous (and insidious), issue of “regulatory capture.” Thus, when the economic costs of regulation outweigh the public interest benefits the regulation was originally designed to achieve, it is clearly time to modify or even outright remove this regulation.<sup>53</sup>

It is also very important to understand that the term “market performance” is very different from the term “competition.” “Competition,” as defined in the dictionary, is just the act or process of “competing.”<sup>54</sup> On the other hand,

<sup>52</sup> See *The Search for Meaning*, *supra* n. 2.

<sup>53</sup> See *Reorienting Economic Analysis* at 32-33 & citations therein; *Market Reconcentration* at 23-24; see also *In re Competition in the Interstate Interexchange Marketplace*, 6 FCC Rcd 5880 (1991) at ¶ 80 (Finding that when there is no nexus between the regulations imposed and current market conditions, such regulation can have a variety of adverse effects on market performance, including, *inter alia*: (1) denying carrier(s) the full pricing flexibility needed to react to market conditions and customer demands and therefore diminishing such carriers’ ability to compete as a full-fledged competitor; (2) creating regulatory delays and uncertainty, stringent regulation reduces the value of carriers’ service offerings; (3) affording competitors substantial advanced notice of another carrier’s price and service changes fosters a “reactive market, rather than a proactive one,” and thus reduces the incentives for competitors to “stay on their competitive toes”; and (4) by negating, in whole or in part, one or more carriers’ ability to take advantage, as other competitors can, of being a “first-mover” in the market, lessens the heavily-regulated firms’ incentive to initiate pro-consumer price and service changes.)

<sup>54</sup> See also Jerry Duvall & Michael Pelcovits, *OPP WORKING PAPER NO. 4 — REFORMING REGULATORY POLICY FOR PRIVATE LINE TELECOMMUNICATIONS SERVICES: IMPLICATIONS FOR MARKET PERFORMANCE* (1980) (analysis should focus on market performance, rather than on market participants’ residual market power); Thomas DiLorenzo & Jack High, *Antitrust and Competition, Historically Considered*, 25 *ECONOMIC INQUIRY* 423, 433 (1988) (rivalry focuses on behavior associated with the verb “to compete,” whereas perfect competition focuses on properties of equilibrium; “[b]ut if [perfect competition model] conclusions are substantially different from conclusions based on rivalry, then the competitive model has very likely misdirected the profession, at least as far as . . . policy is concerned”).

“market performance” indicates whether there is sufficient rivalry to produce static economic efficiencies (declining prices), dynamic economic efficiencies (innovation in new services or technologies), or both. If a market is performing well, then consumers will enjoy other societal benefits (e.g., “Apples in the Schools,” cellular phones for the homeless) and stringent regulation, therefore, should no longer be necessary.<sup>55</sup> As such, regulatory policies, to the extent practicable, should always seek to promote good market performance so that competitive, rather than regulated, markets can emerge.<sup>56</sup>

Given the above, how do we achieve this goal? Easy: by formulating policies designed to establish, to the extent practicable, a structural framework conducive to competitive rivalry, under which firms will be unable to engage in strategic anticompetitive conduct — even if they tried.<sup>57</sup> A market structure that is conducive to competitive rivalry is the *key* to achieving real competition. Unfortunately, however, given: (1) the sea of new regulations spewing forth from the FCC and FERC; (2) a demonstrable trend in attempted and successful reconcentration in both the telecommunications and utility industries; and (3) policies that do absolutely nothing to encourage additional facilities-based entry, it would appear that neither “de-regulation” nor “competition” are occurring in any form that would square with the basic purpose of regulation articulated above.<sup>58</sup>

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<sup>55</sup> See F.M. Scherer and David Ross, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (3rd Ed. 1990) at 4-5.

<sup>56</sup> See *id.* at 7.

<sup>57</sup> See generally, *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209, reh'g denied, 509 U.S. 940 (1993); *A.A. Poultry Farms, Inc. v. Rose Acre Farms, Inc.*, 881 F.2d 1396, 1401 (7th Cir. 1989) (“Market structure offers a way to cut the inquiry [of potential, anticompetitive strategic vertical conduct] off at the pass . . . .”); see also *In re Implementation of Section 19 of the Cable Television Consumer Protection and Competition Act of 1992*, Annual Assessment of the Status of Competition in the Market for Delivery of Video Programming, 9 FCC Rcd 7513 (1994), App. H at ¶ 31 (focus should be on “policy-relevant” barriers to entry); see also DEPARTMENT OF JUSTICE/FEDERAL TRADE COMMISSION ANITRUST GUIDELINES FOR THE LICENSING OF INTELLECTUAL PROPERTY (adopted April 6, 1995).

<sup>58</sup> See, e.g., Michael J. Mandel et al., *A Pack of 800 lbs. Gorillas: A Number of Major Corporate Players is Shrinking. Is that Bad?*, *BUSINESS WEEK* (Feb. 3, 1997). Indeed, many conspiracy buffs now privately concede that there is actually stronger evidence to support the conclusion that there is a direct nexus between the rapid reconcentration trend in the U.S. electricity industry and Order No. 888 than to support the conclusion that Oswald did not act alone because there was another shooter at the “grassy knoll.”

### **B. What is a Transition Period?**

The popular response to this criticism is that present restructuring policies are strictly designed to manage the “transition to competition.” Unfortunately, however, as no one to date (neither private nor public sector) has articulated a clear vision of long-term telecommunications or electric utility industry market structure and performance, this so-called “transition period” to competition may be a very long time to endure. Instead, it often seems that current policies are simply intended to provide nothing more than another justification for increased government intervention — regulatory or antitrust — into the market to reallocate wealth from one sector to another, without any rational nexus to the maximization of overall consumer welfare.<sup>59</sup>

Formulating this vision — and the appropriate mechanisms to implement this vision — requires more than just issuing press releases promising that competition and de-regulation are here. Rather, it is going to take a lot of hard work. As a first step, both the public and private sectors must approach these “restructuring” issues from *both* a static and a dynamic perspective. Otherwise, while it is certainly very nice that everybody can apparently conjugate the verb “to compete” in the same sentence as the word “market” these days (indeed, “competition” seems to be the *de rigueur* buzzword of the Nineties), without a clear vision about long-term industry structure, current regulatory policies may actually *harm* consumer welfare for future generations.<sup>60</sup>

Despite this caveat, a close look at the various economic public-policy paradigms introduced over the last five years nonetheless indicates that a “Potter-Stewart-I-Know-it-When-I-See-It” test of anticompetitive conduct or market power is often an acceptable (and preferred) substitute for sound legal and economic analysis in public-policy decision-making. However, because of the significant societal and economic implications raised whenever government decides to “restructure” one or more major industrial sectors of the American economy, the mere use of economic “buzzwords” — without any

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<sup>59</sup> See Robert J. Samuelson, Telephone Straddle, *THE WASHINGTON POST* (May 14, 1997) at A21; Easterbrook, *supra* n. 50 at 15-16, where Judge Easterbrook accurately observed, “[w]e should expect regulatory programs and other statutes to benefit the regulated group — they need not ‘capture’ the programs, because they owned them all along. The burgeoning evidence showing that regulatory programs increase prices for consumers and profits for producers supports this understanding.”; see also George Stigler, *The Theory of Economic Regulation*, *BELL JOURNAL OF ECONOMICS AND MANAGEMENT SCIENCE*, Vol. 2, (1971) at pp. 2-21.

<sup>60</sup> See Reorienting Economic Analysis at 32; Market Reconciliation at 23-24.

understanding of the likely repercussions of such government intervention — is unlikely to result in any tangible benefits in consumer welfare.<sup>61</sup>

### ***C. You Mean Consumer Welfare is Actually Relevant to Public-Policy Making?***

Yes. That's right folks — consumer welfare is what this whole thing is about. More importantly, however, we must always remember that because consumers perceive that both electricity and telecommunications are some kind of “public entitlement,” if consumers believe that they are not getting a good deal on some product or service, then they tend to call up their elected representatives and start to complain — *loudly*. Obviously, when this occurs, all of our lives become just a little bit more miserable.

This issue is especially acute in both the telecommunications and electric utility industry, where consumers believe that they should have reliable service and just, reasonable (and in their minds) *affordable* rates. The problem, however, is that merely because a price may be “just and reasonable” (*i.e.*, neither excessive nor confiscatory) because of prevailing market conditions, customers may nonetheless perceive that a particular price is still not *affordable* (and therefore *unjust* and *unreasonable*) — even though “affordable” may have no relation to actual cost.<sup>62</sup>

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<sup>61</sup> See The Search for Meaning, *supra* n. 2.

<sup>62</sup> See The Search for Meaning at 8; Reorienting Economic Analysis at 34, 36; see also *Farmers Union Central Exchange, Inc. v. FERC*, 734 F.2d 1486, 1504 (D.C. Cir.), cert. denied sub nom., 469 U.S. 1034 (1984) (The concept of “just and reasonable” must clearly be more than a “mere vessel into which meaning must be poured.”)

Readers should note that price regulation is generally appropriate only where one or more firms can exercise market power by raising prices above competitive levels. If price regulation is, in fact, warranted, however, then it does not mean that government suddenly has a “green light” to prescribe specific prices for goods or services. Indeed, if economic regulation is truly supposed to be a substitute for competition, then, just as in competitive, non-regulated markets, regulation should permit a range of prices for a particular product or service, each of which accounts for different consumer preferences and purchasing capabilities (*i.e.*, volume discounts, superior service quality, etc.). For this reason, basic ratemaking principles instruct that there cannot be one, single, generic industry-wide price under the common “just and reasonable” standard. Rather, the “just and reasonable” standard only requires that prices fall within a “zone of reasonableness” — *i.e.*, that these rates are neither “excessive” (rates that permit the firm to recover monopoly rents) nor “confiscatory” (rates that do not permit the regulated firm to recover its costs). They need not — just like caviar or Rolls Royce limousines — be “fair” or “affordable” for everyone.

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As such, despite the appropriate purpose of regulation articulated above, this political pressure significantly affects the “purity” of this process — *i.e.*, it places pressure (either actual or perceived) on government officials to regulate simply because a particular outcome is unsatisfactory. The economic literature is quite clear that, in reality, regulation often takes place because, even though markets are working well, those who have political power are displeased by the results or they may consider some good or service to be too important to be priced and allocated by unfettered market processes.<sup>63</sup> This pressure is exacerbated by the ubiquitous (and highly insidious) presence of “regulatory capture,” where one or more constituents succeed in convincing officials that competition will never succeed unless they are protected.<sup>64</sup> Given the above, therefore, we really should not be so surprised when we ask ourselves how we all arrived into today’s confusing environment.

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Moreover, the regulator is also going to have to determine whether the firm(s) under its jurisdiction are single-output or, more likely in today’s era of “convergence,” multi-product firms. As such, whenever government attempts to define the “zone of reasonableness,” a primary focus on a multi-product firm’s aggregate profits is irrelevant. Rather, the appropriate scope of government’s inquiry should be whether the specific profits derived from providing regulated products and services (and not from ancillary businesses or investments) are the result of the regulated company’s ability to charge an excessive (*i.e.*, monopoly) rate for the regulated product or service — *i.e.*, the product or service over which it can raise price or strict output absent regulation. If the rate reflects the regulated company’s true costs of providing the regulated product or service, but government nonetheless believes that this J&R rate is “too expensive,” “unfair,” or not sufficiently “affordable,” then it is therefore wholly improper for government to require the regulated firm to “subsidize” the price it charges for its regulated service with ancillary profits just to make the rate more politically “affordable” or “fair.” When this occurs, “affordable” simply becomes an excuse for government to set unlawfully confiscatory rates instead.

As stated above, regulation is supposed to be the substitute for, and not the complement of, competitive rivalry. As such, regulators should attempt to set a rate that approximates the equilibrium price (*i.e.*, where supply equals demand) that a rivalrous market would produce. Thus, if government truly wants to make prices for a “public” good or service more “affordable” — regardless of whether the end-price for this product or service is set by regulation or not — then government should focus its priorities on promoting entry and rivalry, such that firms will be forced to innovate and lower costs and, with such innovation and increased efficiency, force supply and demand to move down and to the right. If this shift occurs, then the entire “zone” should therefore also be forced down and to the right over time. So long as government maintains an “incumbent-centric” approach, however, it will provide firms no real incentive to innovate and lower costs and, as such, true de-regulation and competition will never occur.

<sup>63</sup> See Scherer & Ross, *supra* n. 55 at 9.

<sup>64</sup> See Market Reconcentration at 30; Reorienting Economic Analysis at 35 & n. 25.

#### IV. Examining the Pros and Cons of the Current Restructuring Paradigms

##### A. *Electric Industry Restructuring*

After reviewing FERC's restructuring paradigm and its current effects on market structure, conduct and performance, it unfortunately appears that Order No. 888 and its progeny will probably never lead to tangible competition or "de-regulation." Why do I think this, you ask? *Because FERC officials told me so.*

Unfortunately, FERC officials have stated publicly that even though some may view the concept of "regulated competition [as] an oxymoron like 'postal service' or 'airline food'", they prefer to "think of regulation as evolving into a guardian and guarantor of competition, *instead of its substitute.*"<sup>65</sup> Moreover, FERC officials have stated publicly that "government should not hesitate to intervene where *non-market power values* are deemed worthy of protection, if it can do so in a competitively neutral way and in defense of the competitive interests of the market."<sup>66</sup> Given the above, we really should not be surprised therefore when the Chair of the FERC proudly proclaims that "regulated competition" is perfectly appropriate because FERC will not "*race headlong towards 'de-regulation' that is based largely on untested theories about the behavior of competitive markets.*"<sup>67</sup>

Not that I want to spoil the party here, but the problem with these statements is that they fly in the face of established legal precedent and basic economic first principles. Just to re-emphasize the point one more time for the "neo-competitively-challenged," like it or not,

Economic regulation is supposed to be a *substitute for*, and *not a complement of*, competitive rivalry. It is not, contrary to popular belief, "*because we can.*"<sup>68</sup>

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<sup>65</sup> Hoecker Cites "Misconceptions," Electric Utility Week, March 31, 1997) (emphasis supplied).

<sup>66</sup> Congress Should Mandate FERC Oversight of ISOs, Coalition Says, Inside FERC March 31, 1997 (emphasis supplied).

<sup>67</sup> FERC Chair Hoecker Delivers Scary Halloween Message for Industrials, Foster Electric report, No. 125 (Nov. 5, 1997) (emphasis supplied).

<sup>68</sup> See The Search for Meaning, supra n. 2 at 7 (emphasis in original).

In other words, economic regulation is only appropriate where one or more firms are capable of successfully exercising market power (charging monopoly prices or restricting output) for a sustained period of time, and additional entry is unlikely.<sup>69</sup> Accordingly, if the stated goal of public policy is truly to promote “competition” — and, *a fortiori* lead to tangible “de-regulation” — it is very unclear how FERC’s current restructuring policy will really maximize consumer welfare — *i.e.*, produce, through rivalry, lower prices and more services — in the long-run.<sup>70</sup>

As an initial, general proposition, perhaps it would be a good idea to define what “de-regulation” actually means. According to one utility’s Internet site, the utility attempts to explain “de-regulation” to its customers in the following way: “deregulation,” states the utility, is simply the “reduction or elimination of government regulations controlling an industry.” Moreover, the utility states that it is “also likely that deregulation will give customers more service options, and in most cases, save them money.” These definitions are correct. The big problem, however, is that based on the record to date, FERC apparently does not agree with these definitions. Indeed, given the facts that (a) Order No. 888 and its progeny take up over several thousand pages of paper, and each of these individual pages impose one regulatory constraint after another; and (b) a demonstrable trend in industry reconcentration and no additional entry on the horizon, it is clear that neither “de-regulation” nor competition is occurring in the electric utility industry that would square with the basic purpose of regulation discussed above.<sup>71</sup>

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<sup>69</sup> Id. at 7-8.

<sup>70</sup> Id. at 14; See also Easterbrook, *supra* n. 50 at 40 (“The principle that regulation must extend to catch all substitutions at the margin has a corollary: if you’re not prepared to regulate thoroughly, don’t start.”); See also Reorienting Economic Analysis at 35-36 & n. 33; Walter Adams, Public Policy in a Free Enterprise Economy in *THE STRUCTURE OF AMERICAN INDUSTRY*, (7th ed.) (New York: MacMillan, 1986, Adams, Walter, ed.) at 405, where Adams argued that the primary purpose of economic public policy paradigms should be:

to perpetuate and preserve, in spite of possible cost, a system of governance for a competitive, free enterprise economy. It is a system of governance in which power is decentralized; in which newcomers with new products and new techniques have a genuine opportunity to introduce themselves and their ideas; in which the “unseen hand” of competition instead of the heavy hand of the state performs the basic regulatory function on behalf of society.

<sup>71</sup> See, e.g., Margie Hyslop, Electricity Dereg May Not Lower Rates, *THE MONTGOMERY JOURNAL* (June 4, 1997) at A1; Hiram Reisner, Big Business Wins, Homeowners Lose Louisiana Competition Study Shows, *ELECTRIC UTILITY BUSINESS & FINANCE* (Oct. 7, 1996), reporting that in “terms of the economy as a whole, the benefits of expected lower prices for industrial customers  
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For example, FERC requires everyone (except certain utilities with few or no transmission facilities) to post their prices for transmission (OASIS). However, as even a cursory look at the economic literature would reveal, tariffing is one of the most *effective* price signaling mechanisms available.<sup>72</sup> Thus, having rivals post their prices, coupled with the deliberate creation of a market which is also characterized by: (1) an increasingly diminishing number of such rivals as the industry further reconcentrates; (2) very unsophisticated customers; (3) extremely inelastic supply; and (4) a very homogeneous product in an industry that is clearly not characterized by rapid technological change and innovation, we should not be very surprised if we end up with an oligopoly that can successfully engage in tacit (if not outright explicit) collusive pricing behavior.<sup>73</sup>

Similarly, FERC also requires everyone (again, with small exceptions) to file homogeneous transmission tariffs. Aside from probably violating the *Mobile-Sierra* doctrine, it is very unclear how mandated homogeneity will result in

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do not offset the reduction in disposable income for consumers due to higher residential rates.” In fact, the state would “see an overall reduction in personal income, retail sales, tax revenues, and economic output” for several years. Funny, I thought that the law is pretty clear on this point: The “public interest” may not be used to benefit a particular individual or group; rather, an agency’s actions must be consistent with the interest of “the public” as a whole. See, e.g., *Northeast Utilities Service Co. v. FERC*, 993 F.2d 937, 951 (1st Cir. 1993); see also n. 14 supra and citations therein.

<sup>72</sup> Indeed, as the FCC recognized nearly twenty years ago:

Tariff posting . . . provides an excellent mechanism for inducing noncompetitive pricing. Since all price reductions are public, they can be quickly matched by competitors. This reduces the incentive to engage in price-cutting. In these circumstances firms may be able to charge prices higher than could be sustained in an unregulated market. *Thus, regulated competition all too often becomes cartel management.*

See *Competitive Carrier Further Notice*, 84 F.C.C.2d 445 at ¶ 26-27 (1981); see also *Reorienting Economic Analysis* at 35, & nn. 27-30 and citations therein.

<sup>73</sup> See generally, Phillip Areeda & Herbert Hovenkamp, *ANTITRUST LAW: AN ANALYSIS OF ANTITRUST PRINCIPLES AND THEIR APPLICATION* (1995). Moreover, it is highly likely that this structure will bring an increased risk of antitrust scrutiny from enforcement agencies and other interested parties. Indeed, it is quite unclear how on one hand FERC basically believes it can force the industry to coordinate their pricing and access strategies (e.g., ISOs and power pools) yet at the same time apparently believe that they can “sprinkle” these activities with some kind of “antitrust immunity.”

dynamic economic efficiencies in the long-run. It is nice to see, however, that FERC officials have finally, albeit unwittingly, conceded this point as such.<sup>74</sup>

Moreover, despite Order No. 888's great claims of promoting competition, it is very unclear exactly what utilities are actually competing *for* or *against*. Indeed, it is difficult to discern exactly *what* market FERC is concerned about. *Producers* of bulk power? *Purchasers* of bulk power? Perhaps it would have been a good idea in the first instance to define exactly who the "competitors" and who the "consumers" are in the electric utility industry.

On the "wholesale" level (which is regulated by FERC), both purchasers and producers of bulk power are individual monopolists with exclusive franchise service territories. These monopolies come in a variety of forms, including investor-owned utilities (IOUs), municipalities and rural coops, or federal monopolies (*e.g.*, Tennessee Valley Authority). Often, there may be one or more muni or coop within a particular IOU's service territory. While munis historically bought all of their bulk power from the surrounding utility under "full requirements" contracts, munis would now like to purchase bulk power

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<sup>74</sup> See Foster Electric Report, *supra* note 67 (reporting that FERC intends to "expand upon certain themes" such as "considering whether to revise or enlarge the pro forma tariffs to allow for product and service innovations").

from other, cheaper sources.<sup>75</sup> By doing so, argue the munis, they can offer lower rates to attract and keep industrial and residential customers.<sup>76</sup>

“Retail” competition (which is regulated by the states) in the electric utility industry is a bit of a misnomer, because various special interests deliberately use this term to encompass a broad range of consumers — each with very different demand requirements and cost characteristics — which should not be grouped into a single, homogeneous category.<sup>77</sup> On one hand, people interpret

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<sup>75</sup> However, these “cheaper” sources of generation are often not the result of competitive operational efficiencies, but rather from a utility’s geographic location or load forecasts. For example, utilities which control sources of cheap hydro-electric power (e.g., the Pacific Northwest, Eastern Canada), have plenty of attractive excess power to sell. (Yet, despite the reality that Adam Smith proved that naked mercantilism harms consumer welfare, given FERC’s latest attempts to conduct foreign policy as well by prohibiting the Canadians to sell their cheap power in U.S. markets until they provide reciprocal Order No. 888-style transmission access to U.S. firms, see, e.g., Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities, 70 FERC (CCH) ¶ 61,367 (1997), it is unclear how cheap this Canadian hydro may actually turn out to be.) Similarly, those utilities which, because of recent load forecasts, have invested in substantial new, highly-efficient capacity designed to accommodate long-term demand, also have in the short-term very attractive excess generation to sell. Thus, if a significant wholesale customer bolts from the network, then a utility may actually have to close existing (and perhaps more expensive) plants as uneconomical. However, despite a prior finding by regulators that the utility prudently incurred the costs of these plants when the plants originally went on line, if the plants — with the customer’s departure — are no longer “used and useful,” then the utility will be unable to recover the remaining stranded (i.e., sunk) costs of the abandoned facility.

<sup>76</sup> However, because of the presence of exclusive franchises in the electric utility industry, antitrust courts have consistently recognized that “locational” retail competition is a flawed notion, because consumers generally do not choose where to live or do business based upon short-term electricity prices. See Lawrence J. Spiwak, *Is the Price Squeeze Doctrine Still Viable in Fully-Regulated Energy Markets?* 14 ENERGY L.J. 75 (1993).

<sup>77</sup> See n. 23 *supra* discussing various instances where power marketers are exiting the residential retail electric market in favor of the more profitable industrial market and (especially given the huge sums of money spent on marketing and false promises) is outraging residential consumers. See also Enron’s Pullout Shows Consumers Have the Real Power, LOS ANGELES TIMES (Business; Financial Desk, May 4, 1998) at D4 (“Let me get this straight. Enron says it can’t compete because of the 10% discount residential customers now receive on their monthly phone bills, yet Enron touts energy contracts for millions of dollars with some of the state’s large business and industrial customers.”); Bob Wyss, Cheap Power: Can the Little Guy Get Plugged In?, THE PROVIDENCE SUNDAY JOURNAL (April 26, 1998) at F01 (“Nobody wants to be a sucker. But there has long been a suspicion that the residential electricity customer is the fall guy in all of this talk about competition.”) These reports should not be construed to stand for the proposition that targeting high-volume users over low-volume users is either “anticompetitive” or nefarious. It is not. All lawful businesses operate in this way. What these reports do indicate, however, is that it is possible to compete vigorously with integrity without lying to the American public. See, e.g., Quinn, *supra* n. 23 (Reporting that Atlanta-based Southern Co. had made a decision similar

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the phrase “retail” competition to mean a market that provides residential consumers various alternatives of power providers. However, the driving force behind “retail” competition is not consumer advocates, but is really the large, industrial customers in the IOUs’ service territories (*e.g.*, steel manufacturers, U.S. military bases, *etc.*) who would also like to shop for competitive alternatives.<sup>78</sup> What is important to recognize about these large industrial customers is that they are more than just large, high volume customers. Rather, it is the fact that given these firms’ large load requirements, these industrial customers actually act like a *utility* — *i.e.*, they typically have multiple meters and distribution wires, and substantial on-sight generation capacity which they often must “ramp up” and “ramp down” to help balance their incumbent utility’s load.<sup>79</sup> It is the potential departure of these large industrial users that really is the heart of the feared “death-spiral” and utilities’ underlying desire to protect, and if not recover, their “stranded” costs.

Perhaps, as alluded to above, the most serious concern about FERC’s current policy is Order No. 888’s lack of any real incentive — indeed, empirical evidence indicates that it is actually a *disincentive* — to commit the substantial sunk costs necessary to build any new transmission capacity.<sup>80</sup> Unlike most telecommunications markets — where supply is elastic and continues to shift out; suppliers face a high-own price elasticity of demand; and consumers have enjoyed sustained trends of declining prices and increasing innovation — the energy industry is currently characterized by a highly *inelastic* supply curve — which, over time, will probably constrict as outdated capacity goes off-line and new capacity is not built — and ever-increasing demand.

As explained above, because FERC’s paradigm is essentially designed to let either an exclusive monopolist or “energy marketer” purchase power from a variety of generation sources, but then basically “free ride” off of another monopolist’s constrained transmission system — even though the latter needs

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to Enron’s, but Southern initially focused on winning wholesale and large business customers “before embarking on an expensive sales campaign targeting residences. . . .”)

<sup>78</sup> Because of the huge volume and amount of power these industrial customers require (indeed, often exceeding the requirements of small munis), many people argue that these customers should simply be considered to be some sort of wholesale customer, such that public policy-makers can then honestly debate about the best way to facilitate true residential “retail” competition.

<sup>79</sup> Indeed, it is highly unlikely that a single residential customer’s ability to conveniently use the “Clapper” to “clap on” and “clap-off” their television set would make an equal contribution to help a utility balance its load.

<sup>80</sup> See *supra* n. 40.

all the transmission capacity available to serve its native load — FERC’s policy that owners of transmission facilities must give rival monopolists priority (and dispatch ability) over their own service requirements over constrained facilities has contributed undoubtedly to the various power blackouts occurring around the country, two of which blacked-out the entire West Coast last year.<sup>81</sup> Clearly, this result should not be the result of policies allegedly intended to maximize, rather than harm, consumer welfare.<sup>82</sup> Indeed, if Economics 101 teaches us one thing, it is that when supply shifts in and demand shifts out, prices actually go up and services and quality go down.

FERC’s erroneous misconception about the laws of physics is simply exacerbated by the fact that various public policy officials — including FERC, the States, and even regulators abroad — apparently now believe that these dispatch issues can be resolved by high technology — *i.e.*, by using telecommunications technology, firms can somehow monitor and dispatch each electron on the national grid directly from the magnets straight through to each residential consumer’s door-step.<sup>83</sup> Unfortunately, even if technology can provide real-time pricing and demand-side management efficiently (which the record indicates it does not<sup>84</sup>), because Order No. 888 seeks to establish a

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<sup>81</sup> See, e.g., Sturdivant, *supra* n. 5; Hoecker Troubled by EEI Statements on Outage, *ENERGY DAILY* (Aug. 27, 1997) (Reporting that Commissioner Hoecker criticized EEI’s statement that “there is a tension between coordination and competition, and [. . . that] the Commission’s rules [on competition] are pushing utilities to use [transmission lines] in ways they were not designed for.”); Hoffman, *supra* n. 25 (“While not a direct cause of the western outages, the transition to competitive electricity markets is expected to place further stress on the transmission network.”)

<sup>82</sup> Cf. *Environmental Action, Inc. v. FERC*, 939 F.2d 1057, 1061 (D.C. Cir. 1991), where FERC argued that it was permitted to exclude Qualifying Facilities (QFs) from transmission access conditions imposed under Section 203. The D.C. Circuit disagreed, holding that the Commission’s decision:

simply misconstrues the purpose of antitrust policy, which is not to make competitors equal, or to avoid all forms of advantage; the antitrust laws are for the “protection of competition, not competitors.” *Brown Shoe Co. v. United States*, 370 U.S. 294, 320, 82 S.Ct. 1502, 1521, 8 L.Ed.2d. 510 (1962). Competition is not valued for its own sake but because it is most likely to maximize the satisfaction of consumer wants. Had the FERC looked to the interests of consumers, rather than those of competitors, it would have gone a long way toward avoiding any error in its antitrust analysis. (Emphasis supplied.)

<sup>83</sup> See Interview, FERC Chair James Hoecker, *supra* n. 45 (Retail competition “will develop much more swiftly on the electric side than it has in the city-gate market for natural gas” because “the technology already exists for customer choice at the retail level” and because there “is a greater political focus on competition and customer choice on the electric side.”)

<sup>84</sup> See, e.g., News and Insight on Business in the Golden State Spotlight, *LA Times* (Feb. 23, 1998) at D2 (Reporting that while California retail wheeling experiment had to be postponed for  
(continued ...)

perpetual resale model without providing any real incentive — again, empirical evidence indicates that it is actually a *disincentive* — to commit the substantial sunk costs necessary to build any new transmission capacity,<sup>85</sup> technology unfortunately can overcome neither the laws of physics nor the laws of economics. Accordingly, because this “virtual” competition provided by the information superhighway will nonetheless require the presence of constant (and indeed heavy-handed and *tangible*) regulation, any true benefits for consumers will remain in virtual cyberspace bank accounts, rather than as cold, hard cash in their wallets, as well.<sup>86</sup>

In sum, because exclusive franchises continue to exist and no alternative networks are being constructed, true “residential” end-user consumers somehow seem to be left out of the competition equation — despite the fact that these policies are allegedly intended for their benefit. Indeed, unlike the telecommunications industry (where both exclusive franchises are prohibited and alternative networks to the home are being constructed — e.g., second wire, fixed wireless, mobile), legal, regulatory and structural barriers to entry still prevent any tangible head-to-head facilities-based competition between and among utilities, co-ops or munis.<sup>87</sup> Accordingly, given the current

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at least three months to solve technical problems with hardware and software, officials were “confident” that they would not need a second delay); Electric Shorts, Foster Electric Report, Report No. 130 (Jan. 21, 1998) (Reporting that the United Kingdom’s Office of Utility Regulation recently decided to delay by eight months the full opening of the country’s retail electric utility markets, “citing the same computer glitches and other technical hang-ups that have forced California to delay the opening of that state’s markets to retail choice by three months”).

<sup>85</sup> See Peter Coy, *supra* n. 41. Just to recap, remember these disincentives include, inter alia: permitting utilities to recover only the embedded (rather than the incremental, forward-looking) costs of transmission facilities; having to provide rivals with “network” service (i.e., essentially having to provide multiple rivals — who are often geographically separated and therefore have very different demand and cost characteristics — with the de facto ability to dispatch their system and to have priority over native load requirements); and, as discussed *supra*, continuing residual “obligation to serve”/“carrier of last resort” responsibilities in this so-called competitive environment.

<sup>86</sup> See Lawrence J. Spiwak, Three Reasons Why Utilities Need Telecommunications Expertise — Whether they Like it or Not, *INFRASTRUCTURE*, ABA Section of Public Utility, Transportation and Communications Law (Spring 1998). Indeed, any notion that “state-sponsored, managed competition” — i.e., when regulators order firms, as a condition of providing service, to lower their previously-approved just and reasonable rates to an apparently more “affordable” level — can either actually maximize consumer welfare or be sustained in the long-term is simply specious at best. The Search for Meaning at 7-8, 11-14 and citations therein.

<sup>87</sup> See, e.g., *Town of Concord*, *supra* n. 43, 915 F.2d at 25-26 (even if a utility’s anticompetitive conduct can successfully drive a rival from the market, a “utility [still] could not take over the municipality’s distribution area without the regulator’s permission.”); *Cities of* (continued ...)

economic structure of energy markets outlined above, I do not consider the current retail energy brokering programs — which do nothing more than to reallocate wealth from one firm to another — to be “real” competitive alternatives that consumers can benefit from.<sup>88</sup>

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Anaheim v. FERC, 941 F.2d 1234, 1250-52 (D.C. Cir. 1991) (citing Town of Concord, the D.C. Circuit held that “even if a utility is able to squeeze a competing distributor out of the retail market, the utility still cannot take over the competitor’s franchise without approval from the local regulator.” Moreover, the court further held that because a retail distributor supplies “relatively immobile customers,” retail competition for electric power is “relatively static.”); West Texas Util. v. Texas Elec. Serv. Co., 470 F.Supp. 798, 819-824 (N.D. Tex. 1979) (no antitrust liability where actual and potential retail competition was de minimis). See also, Lawrence J. Spiwak, *Is the Price Squeeze Doctrine Still Viable in Fully-Regulated Energy Markets?* 14 ENERGY L.J. 75 (1993).

<sup>88</sup> See, Agis Salpukas, *California’s Effort to Promote Plan For Electricity Is Off to a Slow Start*, NEW YORK TIMES (Feb. 26, 1998) at D1, D6 (Energy marketer’s offer of a 10% rate cut was not the result of competitive savings, but rather was an automatic bonus — mandated by the California State legislature and paid for by a special bond issue — for every energy user who switched providers in the state.); Agis Salpukas, *Utility Deregulation: Boon or Boondoggle?*, NEW YORK TIMES (Feb. 1, 1997) (business section), reporting that consumers were not aware that most of the alleged savings resulting from New Hampshire’s retail-marketing plan were not the “result of free-market competition or any economies of scale that [a new entrant] might bring to bear on a regional market. Rather, they stem from state-mandated subsidies and from the willingness of . . . marketers to shave their profit margins to near zero to get a piece of the action.” (Emphasis supplied.) The article further reported that while the deregulation of the national market for electricity “might ultimately bring about lower prices in some parts of the country, the monthly bills of the 17,000 New Hampshire residents taking part in the current pilot program could bounce back up if the subsidies are phased out and [the] winners of the marketing battle reward themselves by taking a profit.” Readers should therefore not equivocate the pseudo-benefits produced by this “neo-competition” with the benefits produced by rivalrous competition — i.e., static economic efficiencies in the form of declining prices and dynamic economic efficiencies in the form of new products and services. See, e.g., Lawrence J. Spiwak, *Reconcentration of Telecommunications Markets After the 1996 Act: Implications for Long-Term Market Performance*, Antitrust Report (May 1997) at 17, 19 & n. 8 (explaining how the FCC’s Competitive Carrier paradigm successfully de-regulated the U.S. domestic long-distance market by creating a market structure conducive to competitive rivalry, under which carriers are forced to lower prices, innovate their services and, if necessary, actually pay people to be their customers.); see also Peter Elstrom, *Slugfests: Reach Out and Pay Someone*, BUSINESS WEEK (March 23, 1998) (Reporting that the “truce in the phone wars has broken down” as MCI Communications is accusing arch-rival AT&T of “flooding the market with checks to attract new customers” — estimated to be worth \$368 million in January, up from \$70 million a month in fourth-quarter ‘97 — despite AT&T’s alleged assertions that it is curtailing the practice. According to MCI, “AT&T continues to pay customers to switch carriers, even though it says publicly that the tactic is misguided.” (emphasis supplied)); Scott Woolley, *Get Lost, Buster — Lots of Companies Face a Peculiar Problem: How to Get Rid of Customers*, FORBES (Feb. 23, 1998) at 90 (“What if cut-rate service drives off lower-paying customers? So be it. AT&T loses \$500 million a year on its 15 million ‘occasional communicators,’ who rarely make long-distance calls yet cost plenty to acquire, bill and service.”)

### **B. Telecommunications Industry Restructuring**

For those unfamiliar with the basic issues at hand, the battle over how to restructure the telecommunications industry can be boiled down into a very simple story. At present, the U.S. domestic telecommunications industry is divided into two basic market segments — the “local” market and the “long-distance” market. The interstate long-distance market is currently very rivalrous; individual local markets, as they are usually dominated by a single, dominant incumbent, is not. At the urging of the BOCs, the *1996 Act* is, at bottom, designed to change this structure in favor of a structure characterized by a single, re-vertically integrated local and long distance market where firms sell a variety of bundled products.<sup>89</sup>

To accomplish this goal (and therefore finally permit consumers to enjoy the “one-stop shopping” they have long been craving for), the following regulatory time-line is supposed to occur: (1) the FCC is supposed to write interconnection and access rules within six months from the enactment of the Act;<sup>90</sup> (2) given factor (1), entry is now magically so easy that the numerous potential rivals waiting in the wings will now rush in (much like the great Oklahoma land-rush); (3), given (1) and (2), some ill-defined level of market performance is supposed to occur immediately such that the “public interest” requirement of the “competitive checklist” is satisfied quickly;<sup>91</sup> and therefore (4) the BOCs enter long-distance, cancer is cured, and we all go home.

Many people have criticized the current restructuring of the telecommunications industry. However, because (unlike the electric utility industry) there are various potential technological alternatives to the incumbent’s twisted pair to terminate traffic to the home or office, the possibility of creating a market structure which is conducive to competitive rivalry — unlike the FERC model — is at least plausible.

For example, *1996 Act* seeks to eliminate ostensibly many structural and regulatory barriers to entry in order to accelerate the de-concentration of local telecommunications markets. Hopefully, by creating enough pro-competitive economic incentives, new entrants — and in particular facilities-based entrants — will have sufficient opportunities to establish themselves initially against incumbent, dominant providers. (See, e.g., “exempt telecommunications

<sup>89</sup> See Reorienting Economic Analysis at 32-33.

<sup>90</sup> See 47 U.S.C. § 251 (as added by the Telecommunications Act of 1996).

<sup>91</sup> See 47 U.S.C. § 271 (as added by the Telecommunications Act of 1996).

company” or “ETC” provisions, elimination of exclusive cable franchises, interconnection, number portability, *etc.*) After that, however, all bets are off.

Moreover, to encourage immediate entry into local markets by firms who may not initially have adequate capital or facilities to establish a sufficient “toehold,” the *1996 Act* requires incumbent local exchange carriers to provide, *inter alia*, unbundled loops and resale. However, as stated above, the intended goal of this policy is not to create a permanent resale model, but rather to permit the “appearance” of facilities-based competition in the short-term until new entrants can build their own facilities and eventually bypass the incumbent’s network.<sup>92</sup>

Finally, the Commission is taking advantage of the provisions in the *1996 Act* to eliminate most of, if not all, tariffing and reporting requirements. Why are they doing this? As discussed *supra*, because these regulatory requirements can also contribute to collusive behavior by acting as effective signaling mechanisms. By injecting informational uncertainty into the market, firms will have no choice other than to become more efficient competitors.

## **V. Pro-Competitive Benefits of Utility Entry into Telecommunication**

### **A. The Political Rhetoric**

In the legislative history of the *1996 Act*, Congress finally explicitly recognized that yes, utilities can be vigorous competitors in the telecommunications industry and, with such competition, bring more benefits to consumers.<sup>93</sup> Indeed, Congress specifically stated that:

*Allowing . . . [utilities] to become vigorous competitors in the telecommunications industry is in the public interest. Consumers are likely to benefit when more well-capitalized and experienced providers of telecommunications services actively compete. Competition to offer the same services may result in lower prices to consumers. Moreover, numerous competitors may offer consumers a wider choice of services and options.*<sup>94</sup>

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<sup>92</sup> However, the unfortunate fact that the FCC ignored the law and instead sought improperly to create a perpetual resale model (i.e., “trophy competition”) as political cover to pay for its schools and libraries program — rather than promote correctly tangible, facilities-based entry — is another story altogether.

<sup>93</sup> See REPORT OF THE COMMITTEE ON COMMERCE, SCIENCE AND TRANSPORTATION, S. 652, S. REP. NO. 104-23, 104th Cong., 1st Sess. at 8 (1995) (“Senate Report”) at 7-8.

<sup>94</sup> *Id.* at 7 (emphasis supplied).

To support this position, Congress recognized in the legislative history that utilities in general have experience in telecommunications operations, as these companies already operate telecommunications systems for the operation and monitoring of electric generation, transmission and distribution for reliability purposes.<sup>95</sup> Moreover, Congress recognized that holding companies have sufficient size and capital to be effective competitors to incumbent telecommunications companies.<sup>96</sup> Finally, Congress also found that electric utilities, by entering into telecommunications, could provide more efficient and more ecologically-sound energy service in the form of “peak-shaving” and real-time energy management.<sup>97</sup>

**B. Economic Realities**

However, while “pro-competitive” rhetoric certainly promotes political narcissism, such rhetoric will not promote competitive rivalry unless it is accompanied by well-reasoned, pro-entry policy paradigms. As mentioned briefly above, under the *1996 Act*, a new entrant basically has three ways to enter the local telephone market.<sup>98</sup>

- (1) If the entrant already owns local distribution facilities, then it may simply interconnect with the incumbent. At the present time, this is a very small number of telecommunications companies.
- (2) Given (1), the entrant could elect to build its own facilities, and then interconnect with the incumbent. However, as such an approach is both very time and capital intensive, this option may not be very attractive because market conditions may be radically different when the project is finally ready to come on line.<sup>99</sup>

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<sup>95</sup> Id.

<sup>96</sup> Id.

<sup>97</sup> Id.

<sup>98</sup> What is really interesting to note is that while the 1996 Act is predicated on the belief that privately negotiated agreements — rather than government set prices terms and conditions — is the preferred mechanism to achieve meaningful interconnection, FERC is taking the exact opposite approach, even though the Federal Power Act dictates that rates, terms and conditions are supposed to be set in the first instance by privately negotiated agreements — not by government. See *United Gas Pipeline v. Mobile Gas Service Corporation*, 76 S.Ct. 373, 338-339 (1956); *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 352-53 (1956).

<sup>99</sup> See Olson & Spiwak, *supra* n. 48 at 292-295 (explaining how sunk costs can be significant barriers to entry).

- (3) Finally, a new entrant can elect to purchase resale capacity or unbundled elements from the incumbent carrier. As recent press reports continue to indicate, however, this option is meeting with (to put it politely) limited success.<sup>100</sup>

Utility entry, however, provides a fourth option — *i.e.*, utilities can provide new entrants with the ability to purchase immediately an existing fiber network *which is already sunk*. Indeed, given the huge amount of exogenous and endogenous sunk costs inherent to building a telecommunications network *sui generis*, the unique opportunity for new entrants to obtain an alternative network which will require only *de minimis* incremental upgrade costs is unlike any other industry that I can think of.<sup>101</sup> In addition to having pre-sunk network facilities, utilities also have established brand-names, back-office facilities (*e.g.*, billing and repair capabilities) and a culture which understands the need for rapid response to both customer and regulatory demands. Numerous recent press reports indicate that many new entrants are using successfully this fourth option to create tangible, facilities-based telecommunications competition against the incumbent provider.<sup>102</sup>

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<sup>100</sup> See Linda Woody, CLECs and Incumbents Collide Over Service Issues, X-CHANGE MAGAZINE (June 1987) at 26; Peter Elstrom, Why SBC Shouldn't be the First Bell in Long Distance, BUSINESS WEEK (July 21, 1997) at 33; AT&T's Armstrong Says Small Resale Discounts Delay Residential Competition, TELECOMPETITION REPORT (Feb. 26., 1998) (Reporting that AT&T Chairman Michael Armstrong statement that because the current average discount rate of 22% offered for wholesale local service, coupled with the "lack of [an unbundled network element platform]" means that no one can afford to go into the local exchange business. . . ." As such, Armstrong stated that because AT&T was losing \$3 a month on each customer, AT&T was "not going to spend money on this fool's errand, and that's what [total service resale] is today.")

<sup>101</sup> To wit, look at the success (or lack thereof) of competition from cable overbuilding in the United States.

<sup>102</sup> See, *e.g.*, Central & South West's joint venture with ICG to provide local and long-distance service in Austin and Corpus Christi Texas connected its first customers with local service, CSW Press Release (Aug. 5, 1997); Joint venture announced between Southern Company and ICG to construct 100 mile fiber network to provide local telephone service in Atlanta, ICG Press Release (June 17, 1997); Joint venture announced between PEPCO and RCN to provide Washington, D.C. area residents and businesses with local and long-distance telephone, cable television and Internet services from single supplier, PEPCO Press Release (Aug. 6, 1997); Boston Edison and C-TEC's RCN unit form partnership to offer local phone, long-distance, video and internet access, Boston Edison Press Release (Sept. 30, 1997); Cooperative marketing agreement between TeCom (a subsidiary of Tampa Electric) and EchoStar Communications Corp. allows TeCom to market not only an additional, competitive choice for multichannel delivered program, but also to possibly permit customers to control and access data using the set-top controller, EchoStar Press Release (June 20, 1997).

Moreover, utility entry need not be limited to actually providing service directly to the end user. For example, it has been argued recently that telecommunications policy makers should force the incumbent local exchange provider (ILEC) to “spin-off” major functions of its distribution network (*e.g.*, unbundled local loops, local central office building structures, and ancillary local network components) from the existing ILEC corporate organization and place these functions into in a separate, unaffiliated “LoopCo” organization. By doing so, *all* LoopCo customers (including ILECs *sans* distribution functions and Competitive Local Exchange Carriers or CLECs) supposedly would purchase network elements from LoopCo on a non-discriminatory basis. While this proposal certainly seems attractive on paper, a significant sticking point about this approach is that it will require substantial legislative and/or regulatory efforts to make the proposal work. Given incumbents’ natural recalcitrance against giving up any assets that produce substantial monopoly rents, and the demonstrated proliferation of regulatory capture discussed *supra*, I would not hold my breath in baited expectation of the success of this proposal.<sup>103</sup>

Yet, there may be a way that competitive pressures — rather than regulatory initiatives — can force this divestiture, whether the incumbent wants to disaggregate or not. That is to say, as technology continues to progress and advance, it may be possible for a new entrant to contemplate an entry strategy where they would act as a competitive and ubiquitous alternative *wholesale* distribution provider (*i.e.*, Alternative Distribution Companies or “ADCos”), rather than an entry strategy where they would attempt to act simply as just another end-to-end *retail* service provider. If this entry strategy is successful, then this entry would expand greatly the overall market potential for the distribution business beyond just providing an alternative to the “traditional” loop. When this competitive pressure becomes sufficiently large enough to affect noticeably market structure, conduct and performance, then the ILEC may have a strong financial incentive to disaggregate to retain profits (much like the recent AT&T disaggregation experience). Given utilities’ existing economies of scope and scale, sunk assets and, in particular, their corporate culture of serving the customer, utilities are

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<sup>103</sup> See John Greenwald et. al., Hung Up on Competition, *TIME* (July 21, 1997) at 50 (“[I]f you were a local phone company with 100% of the market, how helpful would you be in allowing a competitor into the area? Exactly.”).

well poised, and have already started (although they may not have intended deliberately to do so), to enter as ADCos.<sup>104</sup>

Accordingly, if we are really committed to improving market performance and correspondingly facilitating actual de-regulation in telecommunications, as alluded to above, encouraging tangible facilities-based competition — for a wide variety of reasons — is the preferred economic solution. As explained above, if supply is *inelastic*, then firms will have the incentive to engage in some kind of strategic, anticompetitive conduct against potential rivals to protect sunk investments. On the other hand, as supply becomes elastic, then firms will instead have the incentive to *compete* against rivals to ensure that their sunk assets will not go under-utilized. Accordingly, while the appearance of an “immediate presence” is certainly nice, without providing any incentives for the market to expand supply — as demonstrated by the FERC experience — such a paradigm really does not contribute to improving long-term market performance.

## **VI. “Form-Over-Substance” as Regulatory Barriers to Utility Entry**

As just discussed, the *1996 Act* provides many pro-entry provision which utilities — given their size, scope and experience — are well poised to take advantage of. As we also just discussed, however, the presence and effect of stringent and ubiquitous regulation on the electric utility industry directly affects utility strategic business planning decisions. Tragically, however, our story cannot end there.

Believe it or not, there is one more category of legal/regulatory barriers that need to be discussed in order to comprehend the difficulties utilities are experiencing when they try to enter telecommunications or information services markets. Ridiculous as it may seem, this category of barriers have absolutely nothing to do with how utilities run their business operations; rather, this category only has to do with a utility’s corporate form and organization — publicly and privately-owned utilities alike. I describe these regulatory barriers as “form-over-substance” regulatory barriers to entry. The particular “form-over-substance” issues confronting publicly- and privately-owned utilities are each examined below.

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<sup>104</sup> See Jerry Duvall, *Entry by Electric Utilities into Regulated Telecommunications Markets: Implications for Public Policy*, PHOENIX CENTER FOR ADVANCED LEGAL AND ECONOMIC PUBLIC POLICY STUDIES WORKING PAPER SERIES (Forthcoming Winter 1998).

### A. *Investor-Owned Utilities*

For regulatory purposes wholly-unrelated to the day-to-day operation of their business, under an anachronistic law dating from 1935, investor-owned utilities may also be stringently regulated by the Securities and Exchange Commission (SEC) under the Public Utility Holding Company Act. PUHCA is triggered not by any particular concerns arising from monopoly status, but strictly by corporate organization. This is because PUHCA is designed to protect investors and shareholders from corporate abuse and not to protect individual ratepayers from unjust and unreasonable rates.<sup>105</sup>

For those unfamiliar with the wild and wacky world of PUHCA, a bit of a primer may be useful. PUHCA classifies holding companies into two categories: exempt and registered.<sup>106</sup> All “public utility holding companies” are presumed to be “registered” unless a holding company can satisfy one of the five exemptions set forth in the statute.<sup>107</sup> If a holding company fails to satisfy one of the five exemptions set forth in the statute, then that holding company is subject to stringent regulation by the Securities and Exchange Commission (“SEC”). This stringent regulation includes, *inter alia*, extensive reporting requirements and severe line-of-business restrictions regarding the activities and investments that registered holding companies are permitted to make

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<sup>105</sup> For a more detailed exegesis about the dual regulatory scheme between FERC and the SEC, please see Lawrence J. Spiwak, *Expanding the FERC’s Jurisdiction to Review Utility Mergers*, 14 *ENERGY L.J.* 385 (1993). It is nice to note, however, that the Administration is finally agrees with me that Congress should close the regulatory loophole between SEC and FERC merger review. See Clinton Electric Competition Plan, *supra* n. 11 at Sections II.B-C. In this way, it might actually be possible to have FERC finally conform the law to the economics, rather than have it continue its efforts to bastardize economics first-principles in its naked attempt to expand the scope of its regulatory jurisdiction. See *infra* n. 109.

<sup>106</sup> See PUHCA Section 3, 15 U.S.C. § 79d.

<sup>107</sup> These exemptions include: holding companies that carry on business within a single state; holding companies that do not operate beyond the state in which they are organized and states contiguous thereto; and holding companies that are primarily engaged in other business than providing electricity or gas. As of this writing, all but sixteen public utility holding companies fail to merit a determination that they are “exempt” from the requirements of PUHCA and are, therefore, regulated by the SEC as “registered public utility holding companies.” However, with the recent trend of utility mergers in the U.S. today, the number of registered public utility holding companies is actually starting to increase. See, e.g., the creation of New Century Enterprises, which is a registered public utility holding company formed to facilitate the merger between Public Service Co. of Colorado and Southwestern Public Service Company.

outside of their core public utility businesses — including investments in both telecommunications and international markets.

On the other hand, if a utility satisfies one of the five statutory exemption of PUHCA, then this utility is classified as an “exempt” public utility holding company — *i.e.*, it is “exempt” from the onerous reporting requirements and line of business restrictions imposed by PUHCA. As such, these exempt companies do not need to obtain prior SEC approval before they may invest in telecommunications or international projects.

Prior to the *1996 Act*, a registered public utility holding company could only enter into “any business (other than the business of a public utility company as such)” that was:

reasonably incidental, or economically necessary or appropriate to the operations of one or more integrated public-utility systems . . . which the [SEC] shall find necessary or appropriate in the public interest or for the protection of investors or consumers and not detrimental to the proper functioning of such systems or systems.<sup>108</sup>

Moreover, the courts and the SEC interpreted these provisions as to require a functional relationship between a non-utility interest and the system’s core utility operations.<sup>109</sup>

Section 103 of the *1996 Act*, which adds a new Section 34 to PUHCA, was designed to eliminate the SEC’s approval process as an impediment to entry for registered public utility holding companies. Under new Section 34(d):

a registered holding company shall be permitted (without the need to apply for, or receive, approval from the [SEC], and otherwise without condition under this Act), to acquire and hold the securities, or an interest in the business, of one or more exempt telecommunications companies.

In turn, Section 34(a)(1) states in relevant part that:

The term “exempt telecommunications company” means any person determined by the Federal Communications Commission to be engaged

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<sup>108</sup> PUHCA Section 11(b)(1).

<sup>109</sup> See, e.g., *Michigan Consolidated Gas Co. v. SEC*, 444 F.2d 913 (D.C. Cir. 1971); *Central and Southwest Corporation et al., Order Authorizing Acquisition of Limited Purpose Communications Subsidiary and Certain Related Financing*, 56 SEC Docket No. 2392, Release No. 35-26061 (1994); see also James W. Moeller, *Electric Utilities and Telecommunications*, 16 *ENERGY L.J.* 95, 117-118 (1995) and citations therein.

directly or indirectly, wherever located, though one or more affiliates (as defined in [PUHCA] Section 2(a)(11)(B)) and exclusively in the business of providing [permitted activities].<sup>110</sup>

There are three basic things neophytes need to understand about the concept of ETCs. First, do not be confused by the fact that the word “exempt” appears in both “exempt public utility holding company” and “exempt telecommunications company.” These entities are totally different regulatory animals. Second, it is *not* the utility who files for a determination of ETC status; rather it is the “person” or entity who will actually “be engaged” exclusively in providing permitted services who files an application. Third, a determination of ETC status bestows absolutely no special regulatory privileges or classification on the applicant. As explained above, the only reason to obtain a determination of ETC status is to eliminate the SEC as a regulatory barrier to entry.

To help illustrate this process, please consider the following hypothetical. I decide to start a brand-new telecommunications and information service company. I plan to call it “Larry’s At-Home Dialing Service,” because I offer to come to your house and dial your phone for a fee, at my convenience. (I include “at my convenience” because, after all, I don’t want FERC to think that whenever I choose not to provide my service to a particular customer — *e.g.*, they live in a bad neighborhood, I’m tired, a good football game is on TV, *etc.* — I have engaged in some sort of “undue” discrimination and therefore they can subject my business to Order No. 888 as well.<sup>111</sup>) I then decide to set up shop where I know there are a lot of senior citizens (the target market) and unemployed college kids (the target employees). My business takes-off — my primary rival, the “I Fallen and I Can’t Get Up” people, can’t match my superior service and lower price — and I decide to cash-out. Under existing

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<sup>110</sup> Despite the fact that Section 34 was primarily designed to remove the SEC as a regulatory barrier to entry for registered public utility holding companies, in an attempt at legislative “fairness,” new PUHCA Section 34(c) also permits exempt public utility to acquire the assets, or an interest in, one or more ETCs as a “safe harbor” from any potential adverse SEC action in the future.

<sup>111</sup> If you think I am kidding, I am not. Considering the FERC’s recent proclivity of asserting jurisdiction over assets, products and services previously thought outside their statutory bailiwick — *e.g.*, mergers among registered public utility holding companies (Illinois Power, 67 FERC (CCH) ¶ 61,136 (1994)), mergers among Wall Street investment brokerage houses (Morgan Stanley Capital Group, Inc., 79 FERC (CCH) 61, 109 (1997)), and the operator of an computer-automated information exchange for sellers and buyers of electricity (Automated Power Exchange, Inc., 82 FERC (CCH) ¶ 61,287 (1998)) — the notion that Jell-O is jurisdictional under the FPA might not be too far away.

law, I can sell my company to basically anyone willing to pay my price without any regulatory interference — *e.g.*, a gas station, America-On-Line, a BOC, a long-distance carrier, an exempt public utility holding company. Yet, because of PUHCA, I must first go through a laborious regulatory approval process if a registered public utility holding company wants to invest in, or outright purchase, my company. To solve this problem, I apply to the FCC for a determination of ETC status, the FCC grants my application (assuming, of course, that I satisfy the requisite statutory criteria) and then I take my official piece of paper and place it safely into my file cabinet. Does this determination of ETC status make me no better off than any other similarly situated company? No. All I have accomplished in this process is to keep all of my investment options open.

The FCC, to its credit, has tried — to the extent practicable — to foster and expedite registered public utility holding company entry as a means of further accelerating the de-concentration of telecommunications markets.<sup>112</sup> On September 12, 1996, the Commission adopted simple and streamlined regulations to implement new Section 34(a)(1) in order to eliminate a significant regulatory barrier to entry for those utilities still subject to the restrictive constraints of PUHCA.<sup>113</sup> As a primary reason for this action, the FCC too recognized that it was “somewhat anomalous[]” that there was “disparate [regulatory] treatment” between exempt and registered public utility holding companies regarding ease of entry into telecommunications.<sup>114</sup> Thus, in order to fulfil the primary goal of Section 34, some of the FCC’s key holdings regarding ETCs have included:

- An extremely straightforward application process for those persons seeking a determination of ETC status. Applicants need only

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<sup>112</sup> See Implementation of Section 34(a)(1) of the Public Utility Holding Company Act of 1935, as added by the Telecommunications Act of 1996, Notice of Proposed Rulemaking, FCC

96-192, GC Docket No. 96-101 (rel. April 25, 1996) at ¶ 7, Report and Order, FCC 96-376, GC Docket No. 96-101 (rel. Sept. 12, 1996) at ¶ 12; Errata, FCC 96-376, GC Docket No. 96-101 (rel. Oct. 28, 1996); see also Southern Information Holding Company, Inc. et al., File Nos. ETC-96-5 et seq., DA 96-951 (OGC rel. June 14, 1996); Southern Telecom Holding Company, Inc. et al., File Nos. ETC-96-8 et seq., DA-96-952 (OGC rel. June 14, 1996); CSWC Southwest Holdings, Inc. et al., File No. ETC-97-2, DA 97-372 at ¶ 4 (OGC rel. Feb. 18, 1997) (The Commission specifically noted that by granting ETC status to a utility/CLEC joint venture, “consumers will gain the very benefits the 1996 Act intended to create — *i.e.*, local phone competition.”)

<sup>113</sup> *Id.*

<sup>114</sup> ETC Report & Order at ¶ 2.

demonstrate that they satisfy the limited statutory criteria referenced above.

- Moreover, ETCs do not actually have to provide service to qualify for a determination of ETC status. Rather, an ETC needs only to be “engaged . . . in the business of” permitted activities.
- In addition, consistent with the plain language of the *Act*, the Commission made it clear that an entity need not be, or affiliated with, a public utility holding company at the time it files for a determination of ETC status. The Commission believed that if it adopted the opposite view, not only would its interpretation be arbitrary and capricious and contrary to law, but that it would also actually deter new entry by endangering potential capital flow to non-utility companies seeking business partnerships with one or more utilities.
- And finally, the Commission specifically stated that it would not look at the “public interest merits” of utility entry in the ETC process — *i.e.*, cross-subsidization, pole attachments, *etc.* After considering the already heavy level of regulation imposed on utilities, the Commission believed that there were more appropriate forums other than an ETC application proceeding to adjudicate these issues.

It should also be noted that, in fact, the FCC’s expedited and forthright approach regarding utility entry after the *1996 Act* was one of the very few recent instances where Congress actually publicly lauded the Commission’s conduct.<sup>115</sup>

Notwithstanding the above, however, PUHCA nonetheless remains as a significant barrier to entry for affected utilities seeking to enter telecommunications markets. First, despite the FCC’s laudable efforts to create a simple, streamlined process, the compliance costs associated with PUHCA are still relatively high. Not only do utilities have to spend money to draft ETC pleadings (which the FCC then has to place out for public notice and comment and then evaluate), but the mere fact that they have to file with the FCC basically forces utilities to announce their business plans to potential competitors. Moreover, even through the *1996 Act* states that applicants are “deemed” to be an ETC immediately upon filing an application with the

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<sup>115</sup> See Joint Letter from Senators Trent Lott and Larry Pressler to Chairman Reed Hundt dated May 2, 1996, thanking the FCC for establishing an expedited ETC process.

Commission, lenders are often unwilling to consummate the transaction until they receive an official document from the FCC granting the application.<sup>116</sup> Indeed, although the Commission has consistently granted all of the ETC applications filed to date on or ahead of schedule, the statute nonetheless provides the FCC with 60 days to act. While 60 days may seem like an eternity for those parties seeking to close a deal, 60 days is more like a nano-second for an agency already swamped with major, industry-wide matters. Similarly, the statute is rather unartfully drafted and — without commenting on specific points — statutory interpretation (*i.e.*, the fear of an adverse action from the SEC if the interpretation is wrong) also acts an impediment to entry.

Accordingly, given the regulatory complexities and economic costs outlined above, it would seem that the far easier and cheaper solution would be to simply repeal PUHCA. Wrong. For some reason, while Congress apparently has no problem “reforming” or “restructuring” everything else in the country, PUHCA reform can never seem to get off the ground. Yet, because the economic costs of PUHCA clearly outweigh the public interest benefits this law was originally designed to achieve, utility entry into telecommunications provides one more compelling reason why PUHCA should be repealed. To begin with, given the purpose of regulation outlined above, *corporate form* clearly should not be the exclusive factor used to determine whether regulation is warranted. Second, as the specific arguments against utility entry discussed *infra* are *identical* to both registered and exempt public utility holding companies, it seems highly specious to argue that, for example, Entergy (a registered public utility holding company) somehow has a greater ability to engage in “evil” conduct because it operates in more than one state, yet at the same time assume that Southern California Edison or PG&E (which are exempt public utility holding companies) are unable to engage in such conduct simply because they provide service primarily to only one state. Indeed, last time I checked, these companies are clearly not “nascent” companies. Finally, and perhaps most unfortunately, with the rapid reconcentration of the electric utility industry currently underway, the market is now starting to see the creation of new registered public utility holding companies, which will now also be saddled with the onerous compliance costs associated with PUHCA.<sup>117</sup>

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<sup>116</sup> Among all of the numerous costs imposed by regulation, perhaps one of the most significant barriers to entry is (to put it politely) “regulatory uncertainty.” That is to say, if you owe the bank a million dollars, then you can’t sleep at night; if you owe the bank \$500 million, however, then the bank can’t sleep at night.

<sup>117</sup> See *supra* n. 105.

### **B. Municipal Utilities and Rural Cooperatives**

Municipal utilities and cooperatives are also facing various “form-over-substance” barriers to entry into telecommunications. In addition to the various generic issues regarding utility entry into telecommunications discussed *infra*, the primary argument against municipal utility entry is that because they are “creatures of the state,” the state can tell them exactly what they may and may not do. Of course, last time I checked, corporations are also “creatures of the state.” Tragically, given the copious amount of lobbying from incumbents, state government and regulators are increasingly taking this view around the country. Yet, if we are really serious about promoting competition, it seems a bit hypocritical to me that states are often more than willing to protect municipals’ exclusive monopoly franchise status for electricity, but are wholly reluctant to permit these municipal utilities to enter into telecommunications and provide head-to-head, facilities-based competition against the incumbent LEC.<sup>118</sup>

This view is truly sad. Recent reports indicate that there are about 2,000 utilities owned by governments and that there are about 910 rural electric cooperatives. Collectively, they own assets which exceed \$20 billion dollars.<sup>119</sup> More importantly, however, given the existing service areas of many municipal utilities and especially rural coops, these utilities are well posed to provide telecommunications service to those high-cost areas where incumbent carriers are reluctant to go — even with universal service support payments. Indeed, the whole reason municipals and coops were created originally was because private, profit-making companies bypassed smaller towns to go after more profitable markets.<sup>120</sup> Accordingly, if universal service is truly a “worthy social goal,” then I would far rather have a local municipal utility or coop fill the void — and provide necessary community services and be a powerful engine for

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<sup>118</sup> Attempts at deterring municipal utility entry arise in basically two ways: First, a municipal utility’s original corporate charter failed to include language that it can also provide telecommunications services and products. Thus, the minute the muni goes to the state legislature to have its charter amended, the process magically becomes bogged down in committee. The second scenario is more disturbing. All around the country, numerous states such as Texas, Missouri, Nevada, Nebraska, Florida, Georgia and Arkansas are currently deliberating, or have already passed, laws which outright prohibit municipal utility entry into telecommunications yet, at the same time, subject them to universal service obligations.

<sup>119</sup> See Geof Petch, Here Comes Ready Kilowatt, X-CHANGE MAGAZINE (May/June 1996) at 34-35.

<sup>120</sup> See Geof Petch, How a Small Town Became a Digital Veg-O-Matic (and Accidentally Reinvented the Concept of Public Utility), X-CHANGE MAGAZINE (Sept. 1996) at 46.

local economic growth — than perpetuate the obscene and expensive systems of smoke, mirrors and subsidies imposed by Congress and the FCC which does nothing but distort market performance and outright deter new entry.<sup>121</sup>

## VII. De-Bunking the Myths About Utility Entry Into Telecommunications

In my experience, arguments against utility entry basically fall into two categories. The first category is what I describe as the “cultural myth” — *i.e.* that utilities somehow have a competitive advantage in telecommunications or that utilities have state regulators in their back pockets. The second category is what I describe as the “cross-subsidization” myth. Each are briefly described below.

### A. *The Cultural Myth*

As just mentioned a moment ago, the “cultural myth” basically has two variations: (1) that utilities somehow have a “competitive advantage” in telecommunications; and/or (2) that utilities have state regulators in their back pockets. Let’s examine both in seriatim.

#### 1. *What Competitive Advantage?*

The argument is that utilities — as new entrants into the telecommunications market — somehow have a “competitive advantage” over either the incumbent monopolist or other entrants is specious at best. As a preliminary point, isn’t the whole purpose of this restructuring exercise to promote competition for telecommunications products and services? As there never was, nor will there ever be, a “level playing field,” the desire to crush less efficient competitors is not in itself anticompetitive.<sup>122</sup> In fact, competition is specifically *supposed* to drive the inefficient out of the market.<sup>123</sup>

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<sup>121</sup> See, e.g., James K. Glassman, Gore’s Internet Fiasco, WASHINGTON POST (June 2, 1998) at A13 (The “real outrage is the way Gore and his supporters have gone about implementing what’s called the “e-rate program” — by trying to hide the astronomical costs and charges from the public and by running the whole show through a complicated array of boards in a system recently declared illegal by the General Accounting Office.”); The Search for Meaning at 14-15; Reorienting Economic Analysis at 34. Indeed, the Glasgow, Ky. Municipal Utility Plant Board’s broad-band system keeps more local cash at home by producing over \$1.2 million per year in reduced cable rates and \$175,000 in savings through more efficient distribution of power. See Petch *id.*

<sup>122</sup> See Town of Concord, *supra* n. 43 at 21-22, wherein now-Justice Stephen Breyer wrote that:

(continued ...)

Indeed, while utilities may have, in fact, more sunk facilities and a more established brand-name than other new potential telecommunications entrants, such “advantages” pale in comparison to the incumbent provider’s established brand name and the incumbent’s control of local bottleneck facilities. Remember, in telecommunications — apparently unlike the electric utility industry — those with wires tend to win. As such, if a new entrant is willing to write a check, build new capacity, and provide consumers with a tangible competitive alternative, the appropriate regulatory response should be: “How can I help you?” — not the other way around.

Moreover, the argument that a company has market power simply because it has a strong brand name is specious at best. To the extent *any lawful business* — utility and non-utility alike — has worked hard to develop brand recognition and customer loyalty well, *good for them!!!* Last time I checked, consumers tend not to purchase products and services from companies (or people) with poor professional reputations. Indeed, to argue that utilities have a “competitive advantage” over the incumbent in telecommunications is about as persuasive as arguing that AT&T — with its well-established brand name

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a practice is not “anticompetitive” simply because it harms competitors. After all, almost all business activity, desirable and undesirable alike, seeks to advance a firm’s fortunes at the expense of its competitors. Rather, a practice is “anticompetitive” only if it harms the competitive process. It harms that process when it obstructs the achievement of competition’s basic goals — lower prices, better products and more efficient production methods.

<sup>123</sup> See *The Search for Meaning* at 21 (“[N]either antitrust nor economic regulation should be used to achieve some sort of a “fair” outcome or establish ‘a level playing field.’ ‘Fair,’ to any self-respecting antitrust lawyer or economist, should be yet another obscene, four-letter word. ‘Competition’ requires rivalry — there is no notion of ‘equity’ in this term.”); Easterbrook, *supra* note 50 (those “who see economic transactions as zero-sum games are likely to favor ‘fair’ divisions of the gains and losses”); Joseph Farrell, *Creating Local Competition*, 49 *Fed. Comm. L.J.* 201, 212 (1996) (It is very “important that the playing field should be leveled upwards, not downwards” because “rules that forbid a firm from exploiting efficiencies just because its rivals cannot do likewise” do nothing but harm, rather than improve, consumer welfare); John Berresford, *Future of the FCC: Promote Competition, Then Turn Out the Lights?* 21-22 (Economic Strategy Institute, May 1997) (The “playing field is never ‘even’ to begin with, and bringing in a lot of regulatory landscape architects and earth-moving equipment will, in most cases, only postpone the emerging competition and the benefits it would bring to consumers.” Thus, once regulators start to level the playing field to be “fair” to one competitor, “all the other competitors will find something unfair to them and will want their valleys to be filled and their mountains and hills to be brought low. The process can become an endless one and, if carried to its logical conclusion, makes the regulator into a cartel manager. This guarantees jobs for the regulators, lawyers and lobbyists, and oligopoly for the so-called competitors, but it will do little for consumers.”)

and nationwide *telecommunications* network — would have a competitive advantage if it decided to enter the electric utility industry over the incumbent and other rivals because AT&T was going to use its in-house back-up generators (the only real relevant asset it owns for purposes of utility entry) to establish a toe-hold in the market.

## 2. *Regulatory Capture*

The second cultural myth is that utilities have the state regulators in their back pockets. Unfortunately, however, nothing could be farther from the truth. Utilities have long-been convenient whipping-boys for local politicians. Why? Just think about. Utility assets are very large, visible and (to some) extremely unaesthetic things to look at. Moreover, as the dictionary's definition of "sunk costs" is often nothing more than a large picture of a nuclear power plant, a utility's ability to exit the market (to put it politely) is limited at best. As such, because utilities are not going anywhere — and everybody knows it — it is very easy to rally the proletariat against the big bad utility to gain political popularity.

Perhaps the greatest master of this game was none other than our own beloved President, William Jefferson Clinton when he was active in state politics. If you think that I am kidding, let's just go to the proverbial video tape. During Governor Clinton's first term as governor of Arkansas, his administration's most famous and most popular battles were fought against Arkansas Power & Light ("AP&L"). In fact, he was known then as a so-called "reform governor" — complete with his own "whiz kids" to run a newly-created Arkansas Energy Department.<sup>124</sup> However, as he and his whiz kids apparently also decided to reform not only the Arkansas electric utility industry, but several other major sectors of the Arkansas economy as well, Governor Clinton lost a supposedly easy re-election.<sup>125</sup> Despite this loss, the former Governor Clinton knew that utility-bashing was still a strong, populist hot-button issue. As such, former Governor Clinton campaigned strongly on utility issues when he sought, and eventually won, re-election to the governor's office.<sup>126</sup>

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<sup>124</sup> Michael Kelly, *The Question of Character* with Michael Kelly, *New York Times Magazine*, *THE SACRAMENTO BEE* (Aug. 14, 1994).

<sup>125</sup> *Id.*

<sup>126</sup> Finos B. Johnson, *Two Utilities Keep Arkansas Public Service Chairman Busy*, *THE DALLAS MORNING NEWS* (Sept. 2, 1984).

Back in office after his involuntary hiatus, newly elected Governor Clinton apparently picked up right where he left off. Governor Clinton's *piece de la resistance* of utility bashing came in the Grand Gulf nuclear plant litigation — affectionately known to many of us as “Grand Goof.” Specifically, Governor Clinton challenged FERC's decision that Arkansas ratepayers — as part of the overall Middle South (now Entergy) System — should have to pay for their *pro-rata* share of the cost of Middle South's Grand Gulf nuclear plant (which just happened to be located in Louisiana). The press reports I found indicate that Governor Clinton unleashed an un-ending stream of vitriolic attacks against AP&L and FERC. Moreover, Governor Clinton often publicly threatened that if this rate-case was not settled to his satisfaction, Arkansas would actually seek to take over (*i.e.*, condemn) AP&L from Middle South.<sup>127</sup>

The only problem with this political rhetoric was it was just that: rhetoric, without and serious analytical backing. Thus, while Governor Clinton was arguing that FERC and AP&L were evil incarnate to seek political favor with constituents, the United States Supreme Court reached the exact opposite conclusion. Indeed, not only did the Supreme Court uphold FERC's allocation decision, but it also found that FERC's allocation proceedings pre-empted a prudence inquiry by affected state commissions.<sup>128</sup>

Thank heavens the cable companies are now around to take some of the heat off.

### **B. The Cross-Subsidization Myth**

The second major argument against utility entry is what I describe as the “cross-subsidization myth.” That is to say, a utility will leverage its monopoly power in the utility industry to take over the telecommunications industry. However, after looking at this argument, it appears that this argument's proponents know nothing about the structure of either the electric utility or telecommunications industries.

First, it is important to clarify that it is completely inappropriate to use the term “cross-subsidization” in this context. “Cross-subsidization” is an

<sup>127</sup> See, e.g., Robert Taylor and Matt Moffett, Middle South Units Ordered to Share the Costs of Grand Gulf Nuclear Plant, *THE WALL STREET JOURNAL* (June 14, 1985); John Obrecht, Economic Struggle Over Grand Gulf Marks Year, *THE ARKANSAS GAZETTE* (Dec. 24, 1984). In fact, Governor Clinton went so far as to direct staff to draft proposed legislation to this effect. *Id.*

<sup>128</sup> See *Mississippi Power & Light Co. v. Mississippi*, 487 U.S. 354 (1988); see also *Mississippi Industries v. FERC*, 808 F.2d 1525 (D.C. Cir.), cert. denied sub nom., 484 U.S. 985 (1987).

economic term-of-art which generally refers to the situation where a dominant firm in one market leverages its market power to cross-subsidize — *i.e.*, price below cost — in the second market, such that it will drive out all of its rivals in the second market and will subsequently be able to recoup its lost rents by charging consumers in the second market supra-competitive pricing. As explained in a moment, given the economic structural characteristics of both the telecommunications and electric utility industries, it is highly unlikely that a utility actually could succeed in this conduct.

Instead, the more accurate description of this view is really a *regulatory failure* argument. That is to say, FERC is responsible for regulating a utility's wholesale rates under the Federal Power Act. Those of us who have endured this process know that FERC has a long and distinguished history of ensuring that captive ratepayers do not pay one red cent for a cost which, in FERC's view, should instead be properly borne by shareholders. Similarly, states regulate a utility's retail rates, and states also share FERC's concern that captive ratepayers should not pay for any costs which should instead be properly borne by shareholders.<sup>129</sup> Thus, given the fact that utilities must endure two layers of comprehensive regulation, it is highly unlikely that a utility could use some sort of monopoly profits to cross-subsidize a telecommunications affiliate.<sup>130</sup>

Let us now take this analysis one step further. Assume that a utility would like to set up a competitive local exchange carrier (CLEC) to compete against the incumbent. The local regulators, however, are concerned that somehow there will be improper self-dealing (*i.e.* cross subsidization) between the utility and its telecommunication affiliate, and therefore require the utility to file every single affiliate contract for regulatory review and approval. The net result of this regulatory intervention, however, is that the regulatory compliance costs far exceed the possible profit opportunities for the utility, and therefore make this CLEC project uneconomical. How should the utility handle this situation?

Perhaps the best way to handle this situation is to apply the facts to the economic realities of the electric utility and telecommunications industries:

- (1) As mentioned above, a utility's rates are fully-regulated at both the wholesale and retail level. The purpose of this regulation is to ensure that the utility cannot charge captive ratepayers monopoly prices.

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<sup>129</sup> Plus, as we all also know, these regulators often tend to take a "cautious" approach just to be on the safe-side.

<sup>130</sup> See Town of Concord, *supra* n. 43 at 22-28.

- (2) Under current basic ratemaking principles, utilities are permitted to recover 100% of telecommunications costs resulting from their regulated utility business.
- (3) Thus, if a utility can obtain a cheaper source of telecommunications then, by definition, its rates should go *down* — not up.
- (4) Moreover, even assuming *arguendo* that a utility succeeds in sneaking past regulators some monopoly profits above its permitted rate-of-return (or even price cap) and decides to use these profits to cross-subsidize its telecommunications affiliate, given the size (both scale and scope) of the incumbent, plus all of the other new entrants into the market, it is highly unlikely that a utility could successfully engage in sufficient cross-subsidization to actually drive its rivals out of the telecommunications market. The net result of such conduct would not be any actual reduction in consumer welfare; to the contrary, consumers would actually enjoy *lower* prices in this situation.<sup>131</sup> As such, it always amazes me when people argue with a straight face that lower prices are actually *bad* for consumers.

Accordingly, as the “cross-subsidization” myth is really an issue of regulatory failure, a utility’s ability to use its existing assets to enter telecommunications really comes down to how individual regulators define exactly what are the “used and useful” assets in a utility’s rate-base — *i.e.*, who actually owns the facilities: ratepayers or the utility? As we all know, there are multiple constituencies which argue that because captive ratepayers “paid” for all of the utility’s assets, any money received by using rate-base assets for unregulated activities must automatically flow 100% back to the ratepayers in the form of refunds and/or lower rates. If we accept this argument *arguendo*, however, this argument really makes no logical legal or economic sense. Indeed, if this argument is taken to its (il)logical conclusion then, by definition, a utility would technically own no tangible assets and instead would serve only as a service company to manage the grid.<sup>132</sup> Unfortunately, such a position just does not square with reality. For example:

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<sup>131</sup> Accord, Access Charge Reform, CC Docket No. 96-262, First Report & Order, 12 FCC Rcd 15982, FCC 97-158, ¶¶ 275-82 (May 16, 1997).

<sup>132</sup> But cf. Dawn Kopecki, Regulatory Hurdles Break Pepco-BG&E Deal, WASHINGTON TIMES (Feb. 16, 1998) at D18 (Regulatory conditions requiring the merged entity to pass through nearly all of the merger savings to ratepayers — not shareholders — forced parties to abandon the deal.).

- (1) If a utility's captive rate-payers are the ones who actually paid for, and therefore own, rate-base facilities, does this also mean *a fortiori* that anyone who bought a vehicle from General Motors — and not GM's shareholders — actually own GM's plants and facilities, because GM used the revenue stream it received from the sale of vehicles to pay for the costs of its plants and operating expenses and provide itself with a profit?
- (2) If the utility serves only as a "service company" — because the captive ratepayers technically own all of the corporation's assets — then why are the utility's shareholders (and not captive ratepayers) liable for all of the debt incurred to build and maintain the facilities in the first instance?
- (3) Similarly, if a utility really serves only as a "service company" to manage the grid, then should not this company also have the ability to exit the market quickly with *de minimis* costs if it so chooses? and
- (4) After a utility fulfills its "obligation to serve" by providing ratepayers with reliable power and just and reasonable rates, do residual ratepayer concerns take priority over a utility's equally legally binding duty to uphold its fiduciary duty to its shareholders?

I think you get my point. However, just in case you didn't, please permit me to share a brief anecdote I recently experienced.

Not too long ago, I received a phone call from one of those state-sponsored consumer ombudsmen regarding utility entry into telecommunications.<sup>133</sup> As you would expect, he was not in favor of it. Mr. Ombudsman raised several points in support of his position. Among other things, Mr. Ombudsman first contended that because utilities are monopolists, they should be barred *per se* from entering telecommunications markets. Mr. Ombudsman further argued that because utilities already have huge stranded assets, they could ill-afford to engage in new, unregulated capital-intensive activities. Moreover, Mr. Ombudsman maintained that utilities currently are sitting on huge cash reserves that they are unwilling to use to upgrade facilities. Of course, argued Mr. Ombudsman, the only way to mitigate these anticompetitive ills was to ensure swift and severe government intervention to protect American consumers. However, because I truly believe that without first undertaking

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<sup>133</sup> For purposes of this article and to respect his anonymity, I will hereafter refer to this person only as "Mr. Ombudsman."

serious cost/benefit analysis, the economic costs of regulation can outweigh any conceivable public interest benefit, I decided to address Mr. Ombudsman's arguments point-by-point.

Point One: "Utilities are Monopolists." Well, yes they are. The only problem with this argument is that they are monopolists in the electric utility market — *not* in the telecommunications market. Indeed, I pointed out to Mr. Ombudsman that if he hasn't already noticed, telecommunications markets already have their very own monopolists, and these firms are quite happy, content and proud about their status and have absolutely no desire to be disturbed. (In fact, they seem to grow stronger every day.<sup>134</sup>)

Point Two: "Stranded Costs." My response to Mr. Ombudsman on this point was really quite simple: I explained to Mr. Ombudsman that the conduct he was complaining about had nothing to do with some kind of strategic anticompetitive conduct. Rather — as I explained above — what he was really upset about was regulatory failure on the part of FERC and the states. Indeed, I explained to him that if he is really so upset about these stranded costs, then he should have used the numerous opportunities available to him to raise these issues in various proceedings before FERC and relevant state commissions.

Point Three: "No Capital Investments." I explained to Mr. Ombudsman that his concerns about the lack of utility investment in improving infrastructure were also linked to regulatory failure. After explaining to him the economic effects of Order No. 888 and its progeny in the same manner outlined above, I told Mr. Ombudsman that if I were running a lawful business in a similar situation, I would probably do the exact same thing. Indeed, I explained to him that he basically conceded my point — *i.e.*, why would any reasonable businessperson invest one red cent of hard-fought cash reserves to improve facilities if they know that the exact moment they do, FERC is just going to reappropriate their wealth and reallocate it to whatever "free-rider"/"competitor" is in favor *du jour*. In fact, if it were me, I would probably just hide my money in a mattress somewhere.<sup>135</sup>

## VIII. Conclusion

As such, I left Mr. Ombudsman with the same message that I leave with you today: If we are truly concerned with promoting consumer welfare —

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<sup>134</sup> See Lohr, *supra* n. 1.

<sup>135</sup> See Easterbrook, *supra* n. 50.

rather than promoting additional government intervention and redistribution of wealth — then the notion that *more* regulation (just because government can) is not the way to achieve this goal. If it is, then we will all still be sitting around here twenty years from now fishing for bass in a barrel full of carp. The real solution is the most direct solution — *i.e.*, it is time to go before the relevant authorities — Congress, state legislatures, FERC, the FCC, state PUCs, *etc.* — and demand that they get their economic policies correct. This approach will take an incredible amount of both corporate courage and of analytical heavy lifting but, unfortunately, we do not have the luxury of time any more.

Indeed, given the recent developments discussed above, it appears that the Clinton Administration honestly believes that it can stretch the word “public” in “public utility” to such an absurd point so as to ignore the basic fact that the generation, transmission and distribution of electric energy is actually a real, high stakes *business*. Yet, if reasonable business executives eventually decide that the risks associated with participating in the electric utility industry far outweigh any conceivable benefit, then these companies will exit the market in search of better investment opportunities. Examples of this exodus — and, given the recent industry reconcentration trend, the lack of new entry — are already starting to appear.<sup>136</sup> Accordingly, any policy which, at bottom, seeks to maximize regulatory efficiency at the expense of consumer welfare should be stopped in its tracks.<sup>137</sup>

Perhaps therefore, this whole issue can best be summarized by asking all of us to ponder this simple, basic question: What economic outcome do we really want? — “ratepayers” or “consumers”? If the latter, then let’s get to work. If the former, however, then let’s just say so and stop the charade. The American public deserves better from its government.

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<sup>136</sup> Perhaps the most prominent example of this exodus from the electric utility industry is the case of Westinghouse. Westinghouse, for those of you who may not remember, was the company that actually invented alternating current. Yet, given the market conditions of the electric utility industry, Westinghouse decided to exit the industry it helped found, and bought the CBS broadcasting network instead. (Bonus historical note: Edison was the proponent of direct current. In an effort to discredit John Westinghouse’s alternating current as an unstable threat to public health and safety, however, Edison claimed that direct current was more easily controlled. To prove his point, Edison proposed that direct current could be used to electrocute a man in a quick and painless manner. Unfortunately, when they strapped the convicted man into “ol’ Sparkey,” it took over eight minutes for him to die. Discredited by such barbarity, Edison was driven from the electric industry — and the company he founded, Edison General Electric Co. — forever.)

<sup>137</sup> See *The Search for Meaning*, *supra* n. 2.