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*Where do we go From Here?*

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## FERC Merger Analysis Post-Order No. 888: Where do we go From Here?

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### I. Introduction

The U.S. electricity industry — once the most stoic of industries — is currently in a state of great turmoil and flux.<sup>1</sup> The root of this turmoil stems directly from Federal Energy Regulatory Commission's ("FERC") ostensible efforts to bring "competition" and "de-regulation" to the electric utility industry through Order No. 888 and its progeny.<sup>2</sup> Rather than attempt to produce tangible, facilities-based competition and additional rivalry, however, FERC's policies instead attempt to create improperly a perpetual resale model based without providing any new incentive — indeed the empirical evidence indicates that FERC's policies are a significant disincentive — to new facilities-based entry.<sup>3</sup> In other words, the flawed "neo-competitive" notion of

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\* President, Phoenix Center for Advanced Legal and Economic Public Policy Studies. The views expressed herein are strictly exclusively those of the author alone, however, and do not reflect the views of the Phoenix Center or any of the Center's individual Adjunct Fellows or Editorial Board Members.

<sup>1</sup> 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."); De'Ann Weimer, *Commentary: Don't Be Shocked By Surges In The Price Of Power*, BUSINESS WEEK (July 27, 1998) at 33.

<sup>2</sup> See *Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities*, Order No. 888, 61 Fed. Reg. 21,540 (May 10, 1996), FERC Stats. & Regs. ¶ 31,036 (1996), *order on reh'g*, Order 888-A, 62 Fed. Reg. 12,274 (March 14, 1997), FERC Stats. & Regs. ¶ 31,048 (1997), *order on reh'g*, Order 888-B, 81 FERC ¶ 61,248 (1997).

<sup>3</sup> See Lawrence J. Spiwak, *Utility Entry into Telecommunications: Exactly How Serious Are We?* PHOENIX CENTER FOR ADVANCED LAW AND ECONOMIC POLICY STUDIES WORKING PAPER NO. 1 (July 1998) (hereinafter "*Utility Entry*"); Lawrence J. Spiwak, *Three Reasons Why Utilities Need* (continued ...)

“competition without change.”<sup>4</sup> To defend themselves against these various state-sponsored free-riders, many incumbents have attempted to reduce costs by merger or acquisition in the hope of realizing some economies of scale and scope. In response to this recent onslaught of Section 203 merger applications,<sup>5</sup> FERC’s has issued a Notice of Proposed Rulemaking (NOPR) to codify its *ad hoc* merger analysis.<sup>6</sup>

As explained below, because FERC’s proposed codification of its various *ad hoc* merger analyses into a single “cohesive” paradigm unfortunately perpetuates the same flawed analytical assumptions underlying FERC’s overall restructuring efforts, FERC’s NOPR simply exacerbates the reality that FERC’s restructuring policies tragically will harm — rather than appropriately benefit

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*Telecommunications Expertise – Whether They Like it or Not*, INFRASTRUCTURE, American Bar Association, Section of Public Utility Law (Spring 1998) (hereinafter “*Three Reasons*”).

<sup>4</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>5</sup> Section 203 of the Federal Power Act, 16 U.S.C. § 824b, requires FERC authorization for mergers or consolidations involving the jurisdictional facilities of a public utility. It also requires Commission authorization for the sale, lease or other disposition of jurisdiction facilities with a value in excess of \$50,000 and for the purchase by a public utility of the securities of another public utility.

<sup>6</sup> *Revised Filing Requirements Under Part 33 of the Commission’s Regulations*, Notice of Proposed Rulemaking, Docket No. RM98-4-000, 83 FERC (CCH) ¶ 61,027; 63 Fed. Reg. 20,340 (April 24, 1998).

— overall consumer welfare. These analytical flaws include, but are certainly not limited to:

- ◆ A total mis-application of the Department of Justice/Federal Trade Commission 1992 Horizontal Merger Guidelines, including, for example:
  - ◆ “gerrymandering” product and geographic market definitions to reach pre-determined outcomes; and, *a fortiori*,
  - ◆ the erroneous over reliance upon, and application of, the Hirschman-Herfindahl index (HHIs) to determine whether or not a firm has the ability to exercise successfully market power.
- ◆ A conspicuous and copious absence of any citation to legal precedent or economic literature.
- ◆ A total mis-understanding about the law and economics of vertical integration, including, in particular, the discredited notion that all vertical integration is *per se* anticompetitive.
- ◆ Requiring merger applicants to reveal both prior proprietary transactions and potential business strategies (and, for good measure, make them responsible to gather and supply FERC with this same exquisitely sensitive business information from their rivals as well).
- ◆ A deliberate ignorance of FERC’s own prior findings and decisions regarding the market.
- ◆ A deliberate refusal to inquire whether a proposed transaction will create any merger-specific harms (the true purpose of any merger review).
- ◆ And, consistent with FERC’s other major policy initiatives, a deliberate refusal to articulate clearly an economically rational vision of long-term market structure, conduct and performance.

The purpose of this paper, however, is not to criticize just for the sake of critique, but to contribute positively to the public dialectic. Indeed, the debate over the structure of the U.S. electric utility industry — perhaps the key input that keeps our society from total anarchy — is far too important for interested persons to remain silent about. Accordingly, this paper highlights several of the major analytical flaws in FERC’s merger NOPR, and shows why these flaws need to be corrected immediately before the restructuring process moves forward.

## II. Policy Statement and Merger NOPR

On April 16, 1998, FERC issued a Notice of Proposed Rulemaking (NOPR) to codify its recent merger policy. Essentially, the NOPR seeks to achieve five things. First, it “reaffirms” the Commission’s *ad hoc* horizontal market power analysis and proposes specific filing requirements for horizontal mergers consistent with the analysis set forth in Appendix A of FERC’s 1996 Policy Statement on utility mergers.<sup>7</sup> Second, the NOPR proposes a vertical market power analysis and accompanying filing requirements for mergers that raise vertical market power concerns. Third, FERC’s merger NOPR proposes to streamline filing requirements and lesser information burden for mergers that raise no competitive concerns. Fourth, the NOPR sets out a specific computer simulation model for debate and discussion, and asks for industry comment on this particular model and on the use of modeling in general. Finally, the NOPR proposes to eliminate certain filing requirements in Part 33 of FERC’s rules of practice and procedure that are outdated or no longer useful to aid the Commission in analyzing mergers. Because of space and time constraints, however, this paper will focus only on the legal and economic flaws raised by FERC’s proposed codification of its horizontal and vertical merger review paradigm, and how these flaws tragically postpone the opportunity to achieve any real tangible competition and de-regulation in the U.S. electric utility industry.<sup>8</sup>

### A. FERC’s Horizontal Screen Analysis

#### 1. General Points

##### a. FERC’s Bastardization of the DOJ/FTC 1992 Horizontal Merger Guidelines

After years of refusing to even acknowledge the potential usefulness of using the Department of Justice/Federal Trade Commission Joint 1992 Horizontal Merger Guidelines, FERC dramatically reversed itself in its Policy

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<sup>7</sup> *Inquiry Concerning the Commission’s Merger Policy Under the Federal Power Act: Policy Statement*, Order No. 592, FERC Stats. & Regs. ¶ 31,044 (1996), *order on reconsideration*, 78 FERC ¶ 61,321 (1997) (Policy Statement).

<sup>8</sup> To the extent that any regulator proposes to eliminate, waive or streamline unduly burdensome and economically wasteful rules — as FERC is proposing to do in its NOPR, however — then the regulator should be profusely praised and encouraged.

Statement and NOPR.<sup>9</sup> Rather than adopt the Guidelines *in toto*, however, FERC is proposing to selectively pick and choose only those elements it finds useful and to disregard the rest. As explained more fully below, however, public policy choices cannot be made with the same cavalier attitude as when one selects dishes from a menu at a Chinese restraint.

To wit, under FERC's interpretation of the Guidelines, there are five key questions to any merger analysis:

- (1) whether the merger would significantly increase concentration;
- (2) whether the merger would result in adverse competitive effects;
- (3) whether entry would mitigate the adverse effects of the merger;
- (4) whether the merger would result in efficiency gains not achievable by other means; and
- (5) whether, absent the merger, either party would likely fail, causing its assets to exit the market.<sup>10</sup>

FERC explains, however, that its competitive screen analysis focuses primarily on the first step — *i.e.*, whether the merger would significantly increase concentration. In FERC's view:

Concentration statistics indicate that a merger may have adverse competitive effects, but they are not the end of the analysis. If the applicants' competitive screen analysis indicates that the merger would significantly increase concentration, the applicants must either address the other steps in the Guidelines or propose measures that would mitigate the adverse

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<sup>9</sup> U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, 57 Fed. Reg. 41,552 (1992), *revised*, 4 Trade Reg. Rep. (CCH) ¶ 13,104 (April 8, 1997); and *see, e.g., Northeast Utilities Company (re: Public Service Company of New Hampshire)*, Opinion No. 364, 56 FERC ¶ 61,269, at p. 62,008 (1991), *order on reh'g*, Opinion No. 364-A, 58 FERC ¶ 61,070, *order denying reh'g*, Opinion No. 364-B, 59 FERC ¶ 61,042 (1992), *aff'd in relevant part, Northeast Utilities Service Co. v. FERC*, 993 F.2d 937, 947-48 (1st Cir. 1993) ("The statute, however, does not require FERC to analyze proposed mergers under the same standards that the Department of Justice. . . must apply). *See also id.* ("There is no evidence that Congress sought to have the Commission serve as an enforcer of antitrust policy in conjunction with the Department of Justice and the Federal Trade Commission").

<sup>10</sup> 63 Fed. Reg. at 20,341.

competitive effects of the proposed merger. If applicants propose mitigation measures, the screen analysis should also take into account the effect of the remedy on market concentration to the extent possible.<sup>11</sup>

To conduct this analysis, FERC would use the Hirschman-Herfindahl Index or “HHI” as its concentration statistic.<sup>12</sup>

b. *Legal and Economic Reality*

Despite FERC’s efforts to appear that it is conducting a rigorous DOJ-style analysis by using the Guidelines as an analytical road map, the sad reality is that FERC is only paying superficial “lip service” to them.<sup>13</sup> As FERC openly admits, it is picking and choosing those elements of the Guidelines that it believes are most applicable to FERC’s public interest mandate. While FERC certainly has the legal authority to do so, however, it cannot use the Guidelines in such a way as to render the economic foundation underlying the Guidelines totally meaningless.

As explained more fully below, as a general proposition, the Guidelines — because of their significant reliance on concentration ratios and “non-

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<sup>11</sup> *Id.* at 20,344.

<sup>12</sup> The Hirschman-Herfindahl Index measures the level of market concentration in a particular market. As discussed *supra*, however, it does not indicate firms’ ability to exercise market power, because it does not measure, among other things, supply and demand elasticities or the presence of lack of barriers to entry. The HHI is calculated by summing the squares of the individual market shares held by all participants in the market. Thus, for example, the HHI for a market characterized by ten firms, each with an individual market share of 10%, would be 1,000. A market characterized by a monopoly would have an HHI of 10,000.

<sup>13</sup> See *The Search for Meaning* at 9-10:

Unfortunately, while numerous people in both the private and public sectors seem to enjoy bandying this phrase about, it is increasingly evident that many of these people have no real idea about its exact meaning. “Competition” is neither some utopian destination like Xanadu or Nirvana nor a tangible object that we can reach out and touch and comfort ourselves with. Indeed, because economic terms actually have technical meaning, the mere ability to conjugate the verb “to compete” in the same sentence with the word “market” does not necessarily mean that one understands economic theory—*e.g.*, how the presence of high sunk costs affects both entry decisions and strategic behavior to protect sunk assets; the economic costs of residual “public interest” obligations such as “universal service” or an “obligation to serve”; the economic costs of advanced tariffing and reporting requirements.

transitory” increase in price — are ill-suited for mergers in the electric utility or telecommunications industries, because they do not (nor were they ever intended to) apply to highly concentrated and, in particular, heavily *regulated* markets. For example, the Guidelines are ill suited to account for the presence of stringent regulatory distortions on the structure, conduct and performance of an industry. Indeed, how can you have a non-transitory increase in price when price is controlled (or, at minimum, substantially influenced) by the regulatory process? Moreover, if you have a monopoly pre-merger, and you have just a “bigger” monopoly post merger, the HHI’s *remain the same* (i.e., 10,000).<sup>14</sup> For these and other reasons, therefore, it is black letter antitrust law and economics 101 that market share, in and of itself, does not indicate the ability to exercise market power successfully. Rather, the analysis must always move beyond concentration ratios and toward the evaluation of the elasticities of supply and demand and, in particular, the presence (or lack thereof) of barriers to entry.<sup>15</sup>

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<sup>14</sup> Similarly, take the situation where two contiguous cable systems want to merge (or “cluster”) in order to achieve the sufficient size and scope necessary to provide competitive telephone service to the incumbent LEC. Prior to the merger, each cable firm will probably have a respective HHI of around 10,000 for their respective service areas, as each enjoyed a lawful monopoly in the form of a franchise for many years. When the two companies merge, the merged entity will continue to be the dominant provider of cable service and, as such, the HHIs for cable service will probably remain at 10,000. However, if the merged firm now attempts to provide competition for local telephone service, its market share in the “local loop” market will be *zero* as a new entrant. Therefore, should a competitive inquiry be based upon a static analysis of a “cable” merger within arbitrary franchise territories, or rather the more dynamic possibilities that a new cable “cluster” may facilitate local phone competition in a regional area? Clearly, the answer should lie with the latter approach. See Lawrence J. Spiwak, *What Hath Congress Wrought? Reorienting Economic Analysis of Telecommunications Markets After the 1996 Act*, ANTITRUST, Spring 1997, at n. 17 (hereinafter “*Reorienting Economic Analysis*”).

<sup>15</sup> See, e.g., *United States v. General Dynamic Corp.*, 415 U.S. 486, 498 (1974)(market share is an imperfect measure because market must be examined in light of access to alternative supplies); *United States v. Baker Hughes, Inc.*, 908 F.2d 981, 986 (D.C. Cir. 1990) (Thomas, J.)(market share statistics “misleading” in a “volatile and shifting” market); *Hunt-Wesson Foods, Inc. v. Ragu Foods, Inc.*, 627 F.2d F.2d 919, 924 (9th Cir. 1980), *cert. denied*, 450 U.S. 921 (1981)(“Blind reliance upon market share, divorced from commercial reality, [can] give a misleading picture of a firm’s actual ability to control prices or exclude competition.”); *United States v. Syufy Enterprises*, 903 F.2d 659, 657 (9th Cir. 1990); *Ball Memorial Hospital, Inc. v. Mutual Hospital Ins. Inc.*, 784 F.2d 1325, 1335-36 (7th Cir. 1986); *Southern Pacific Communications Co. v. AT&T*, 740 F.2d 980, 1000 (D.C. Cir. 1984), *cert. denied*, 470 U.S. 1005 (1985) (When a “predominant market share may merely be the result of regulation, and regulatory control may preclude the exercise of market power . . . in such cases (continued ...)

c. *Analytical Specifics*

According to FERC, its competitive screen analysis is made up of four steps:

- (1) identify the products sold by the merging firms;
- (2) identify the customers affected by the merger;
- (3) identify the suppliers in the market; and
- (4) analyze the merger's effect on concentration.

Let's review each step in seriatim.

~~Step 1:~~ *Identify the Products Sold By The Merging Firms*

a. *FERC's View*

Under the NOPR, merger applicants must identify the wholesale electricity products sold by the merging firms. At a minimum, FERC believes that such products would include non-firm energy, short-term capacity (or firm energy) and long-term capacity. Significantly, however, FERC nonetheless asserts that the "role of long-term capacity markets appears to be diminishing" because as "restructuring in the wholesale and retail electricity markets progresses, short-term markets appear to be growing in importance." Indeed, because the crux of FERC's merger "screen" — the "delivered price test" (discussed *infra*) — requires applicants to identify those suppliers with the ability to deliver energy to relevant markets as measured by their short-term variable costs,

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market share should be at most a point of departure in determining whether market share exists."); *Metro Mobile CTS, Inc. v. NewVector Communications Inc.*, 892 F.2d 62, 63 (9th Cir. 1989) ("Reliance on statistical market share in cases involving regulated industries is at best a tricky enterprise and is downright folly where . . . the predominant market share is the result of regulation."); see also, Duncan Cameron and Mark Glick, *Market Share and Market Power in Merger and Monopolization Cases*, 17 *MANAGERIAL AND DECISION ECONOMICS* 193 (1996) (legal precedent requiring courts to draw inferences about market power based primarily or exclusively on market shares and/or market concentration can often be misleading; the only alternative to such bright-line rules is to utilize modern economic tools to undertake more extensive competitive analyses); *Reorienting Economic Analysis* at 32, 34 (In analyzing the structural characteristics of telecommunications markets [post-1996 Act], it is also important not to exaggerate the relevance of the Hirschman-Herfindahl Index (HHIs). Given the technology of the telecommunications industry, many markets will probably be characterized by the presence of one or more firms with a predominant market share.)

FERC tentatively concludes that “there is no good measure for long-term capacity prices *per se*.”<sup>16</sup>

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<sup>16</sup> 63 Fed. Reg. 30,344.

b. *The Legal and Economic Reality*

There is an old proverb in academia: “sometimes the lack of information is also evidence of information itself that also must be accounted for.” In this case, it is FERC’s refusal to account for long-term capacity as a relevant product market.

Why is this important? Because given the current and prospective structure of the U.S. electricity industry, it will be impossible for any restructuring initiative to improve market performance (and *a fortiori* maximize consumer welfare) so long as FERC continues to believe erroneously that public policies need not provide any new incentive for new investment — *especially new investment in highly concentrated markets*—because existing capacity will permit consumers to live on the margin today and in perpetuity.<sup>17</sup> Making matters even more obtuse is the fact that FERC fails deliberately to distinguish between long-term *generation* capacity and long-term *transmission* capacity. If the former, assuming *arguendo* that FERC’s “commodity” model — *i.e.*, generation is a commodity (variable prices) delivered over an “open-access”/“common carrier” transmission grid subject to homogeneous *pro forma* tariffs (*i.e.*, “static” prices) — is correct (which FERC asserts but never demonstrates), then at least with new generation buildout and construction, an exclusive reliance on short-term capacity may not necessarily harm consumer welfare in the near and medium term. To wit, if it is possible to construct new capacity quickly (*i.e.*, short-run capacity) or have plant where the short-run costs are generally *equal* to long-run costs (*e.g.*, hydro plants), then it will be possible to live at the margin for the foreseeable future without any welfare loss. The problem, however, *is that we don’t know if we live in this world because FERC refuses deliberately to undertake a serious and honest inquiry into the matter.*

FERC’s erroneous belief that it is possible to live “at the margin” creates even greater public policy implications in the context of transmission facilities. Indeed, even the Antitrust Division of the U.S. Department of Justice specifically warned FERC just under five years ago, “[d]espite the theoretical advantages of marginal-cost pricing for short-run transmission transactions, *there are also serious difficulties, and the Department recommends that the*

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<sup>17</sup> See *The Search for Meaning* at 12 & citations therein (“True competition means the ability to succeed *and* the ability to fail. However, because many current policies often permit inefficient firms to remain in (and are, in fact, specifically designed to prevent any possible exit of these inefficient firms from) the market, such policies add nothing more than additional impediments to the successful creation of a properly working market. If we have learned anything from history, it is that it is impossible to have ‘competition without change.’”); *Utility Entry passim*.

*Commission not dictate such pricing.*<sup>18</sup> DOJ set out a plethora of reasons in support of this recommendation, including, but not limited to, the basic economic facts that:

- (1) The revenue produced by short-run marginal cost pricing may fall well short of total costs and, in that event, the use of marginal-cost would necessitate subsidies to transmission owners and such subsidies are unlikely to be forthcoming.<sup>19</sup>
- (2) Marginal congestion costs are not easily measured, because they would have to be assessed for all lines at all possible times and are likely to fluctuate widely depending on the time of year and time of day. As such, the administrative costs of making these assessments would be “considerable.”<sup>20</sup>
- (3) Transmission pricing has an option value and, as such, a utility that maintains transmission capacity for economy transactions should not be required to use that capacity to serve someone else — long-term or short-term — unless the compensation exceeds the expected value of the capacity in making economy transactions.<sup>21</sup>

Given the above, the DOJ warned that any attempt by FERC impose short-run marginal-cost pricing would produce significant harm to overall consumer welfare in several significant respects. For example, such a pricing policy would result in “rates that are uncompensatory and that send inappropriate signals.” As the DOJ tried to explain to FERC:

Investments in existing transmission facilities are “sunk;” the capacity will not leave the industry if rates fall to the level of line losses or even below that level. *Rates that low would seriously*

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<sup>18</sup> See Nov. 4, 1993 Comments of the U.S. Department of Justice in Response to Notice of Technical Conference and Request for Comments, *Inquiry Concerning the Commission’s Pricing Policy for Transmission Services Provided by Public Utilities Under the Federal Power Act*, FERC Docket No. RM93-19-000 (hereinafter “DOJ Comments”) at 9.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

*undermine the incentive to make new investments in transmission, and efficient long-term transactions, which are vital to competitive markets for bulk power, could be precluded by the lack of available capacity. Moreover, if prices for short-term transactions were well below those for long-term transactions, there would be significant substitution from long-term to short-term transactions to take advantage of the price differential. Thus, in addition to not being compensated for congestion costs and loss option value, utilities also might not be compensated for capital costs associated with transactions that are, in truth, long-term.<sup>22</sup>*

Unfortunately, however, the parade of horrors does not end here. As the DOJ further explained to FERC,

*If prices for short-term transactions were set to low, there would also be a need for some sort of non-price rationing of capacity at certain times. The Commission would have to determine on an hourly basis how much capacity each utility must make available to others rather than to serve native-load customers. The administrative costs would be substantial, and significant inefficiencies likely would result from inevitable errors of judgment.<sup>23</sup>*

Accordingly, because it is a known fact that existing transmission capacity is already severely constrained, it would therefore seem highly appropriate for U.S. public policies to aggressively *encourage*, rather than actively *discourage* new investment.<sup>24</sup> So long as FERC continues to refuse to abandon its flawed, short term, static approach to the problems of the world (along with FERC's

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<sup>22</sup> *Id.* at 10 (emphasis supplied). See also David Evans & Richard Schmalensee, *A Guide to the Antitrust Economics of Networks*, Antitrust, Spring 1996, at 36, 38. The authors explain that because many network industries are characterized by high fixed costs and low marginal costs, 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 such as volume discounts, special deals, and complex pricing systems."

<sup>23</sup> *Id.* (emphasis supplied).

<sup>24</sup> "Appropriate" (among other adjectives), however, is not exactly the first word that comes to mind when one thinks of FERC.

numerous other entry-detering policies), however, then FERC's current restructuring efforts are tragically doomed to fail.<sup>25</sup>

FERC also appears to be just as hostile to the notion that parties can better (*i.e.*, more efficiently) allocate resources over the long-term through private negotiation than government can by regulation. Indeed, FERC's hostility to anything long-term is completely in accord with FERC's recent surreptitious policy to abrogate all privately-negotiated, long-term contracts in its neo-competitive effort to "level the playing field."<sup>26</sup> As a general proposition, it is perfectly legitimate for government to intervene (either by regulation or antitrust) if the economic costs imposed by a long-term contract outweigh the efficiencies created by the contract.<sup>27</sup> This situation often referred to as a "policy relevant barrier to entry," and is the very root of the FCC's program access policies<sup>28</sup> and the "public interest" exception to the *Mobile Sierra* doctrine<sup>29</sup> set forth in *Papago*.<sup>30</sup> In order to determine whether a long-term

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<sup>25</sup> See *Three Reasons and Utility Entry*, *supra* n. 3, *passim*.

<sup>26</sup> See, *e.g.*, *City of Bedford, Virginia et al.*, 64 FERC (CCH) ¶ 61,381 (1993) (Commissioners Hoecker and Santa dissenting).

<sup>27</sup> Indeed, exclusive distribution contracts have long provided fertile grounds for protracted antitrust litigation. See James Olson & Lawrence Spiwak, *Can Short-Term Limits on Strategic Vertical Restraints Improve Long-Term Cable Industry Market Performance?* 13 *CARDOZO ARTS & ENT. L.J.* 283 (1994).

<sup>28</sup> *Id.*

<sup>29</sup> See *United Gas Co. v. Mobile Gas Corp.*, 350 U.S. 332, 339-343 (1956); *FPC v. Sierra Pacific Power Co.*, 350 U.S. 348, 353-55 (1956). Under the *Mobile-Sierra* doctrine, an administrative agency has the power to prescribe a change in contract rates when it finds them to be unlawful, and to modify other provisions of private contracts when necessary to serve the public interest. See *Western Union Telegraph Co. v. FCC*, 815 F.2d 1495, 1501 (D.C. Cir. 1987). As Judge Bork once explained,

Although the legal standard for changing contract rates (they must be "unlawful") differs from the standard for changing other contract provisions (they must disserve "the public interest"), in fact the two standards are not very different. Before changing rates, the Commission must make a finding that they are "unlawful" according to the terms of the governing statute, which typically requires a finding that existing rates are unjust, unreasonable, unduly discriminatory, or preferential. But as the Supreme Court recognized in *Sierra*, complaints about existing rates do not concern the Commission unless the problems raised are sufficiently serious to "adversely affect the public interest." *Id.* at 1501, n. 2 (citations omitted).



As a general proposition, while it is crucial to identify first the correct product market when conducting a competitive analysis, defining formal, mechanistic boundaries for the relevant “geographic market” at the outset is not. By placing inappropriately too much priority on identifying initially the relevant geographic markets, regulators can (and often do) improperly attempt to gerrymander geographic market definitions to ensure that pre-determined political outcomes can be achieved with a minimum amount of analytical and intellectual effort.<sup>34</sup> Indeed, as FERC readily admits, because electrons do not respect state boundaries, it seems to be a great waste of analytical time and effort to attempt to draw arbitrarily “local” boundaries when utility service areas can be local (*i.e.*, municipalities and coops), state-wide, multi-state holding companies, and now — with the on-going “Great Generation Swap”<sup>35</sup> — even *national* in scope.<sup>36</sup>

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<sup>34</sup> See generally, Franklin M. Fisher, et al., *Folded, Spindled and Mutilated: Economic Analysis and U.S. v. IBM* (MIT Press 1983); see also Lawrence J. Spiwak, *Reconcentration of Telecommunications Markets After the 1996 Act: Implications for Long-Term Market Performance (Second Edition)*, PHOENIX CENTER POLICY PAPER SERIES NO. 2 at 33-36 (July 1998) (hereinafter “*Second Edition*”) (criticizing Federal Communications Commission’s exclusive use of LATA 132 (New York metropolitan area) as the only geographic market relevant to the FCC’s analysis of the merger between Bell Atlantic and NYNEX).

<sup>35</sup> 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 minimize operational distortions on  
(continued ...)

Second, identifying the *number* of buyers and sellers in a market is not the exclusive criteria for how one defines the geographic boundaries of a relevant market. This is because under standard industrial organization economics, the *number* of purchasers is only one of a number of economic characteristics that make up the overall *structure* of the market, which is in turn affected by a variety of *basic conditions*. This structure then affects firms' *conduct*, which determines the market's overall *performance*.<sup>37</sup> Accordingly, FERC should not reduce its analysis to mere bean counting; rather it must focus on a wide variety of structural characteristics of the market to determine whether the proposed merger is likely to enhance, harm, or simply be neutral to, the economic performance of the overall market.<sup>38</sup>

For example, when attempting to identify the number of purchasers in wholesale electricity markets, FERC must also inquire as to how current and post-merger market conditions affect the conduct of these firms. This is because the significant network externalities inherent to the electric utility industry (in particular, the prevalent use of "average system cost" pricing) permit large industrial and full-requirements customers to use successfully their substantial "bargaining" power to exert better deals from their traditional suppliers – *i.e.*, they can threaten, and can often afford, to go off line and cause local utility to incur a temporary "death spiral." To prevent this economically and politically disastrous scenario from occurring, utilities are now often forced to subsidize these large customers either from profits or by raising the rates of other classes of customers.<sup>39</sup>

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the national distribution grid just to provide politicians with the "appearance" of competition that politicians demand to observe. See *Three Reasons*, *supra* n. 3 at n. 17.

<sup>36</sup> To wit, do we really care what the geographic boundaries of the "computer" market are? No, nor should we care. All we need to know is that it is performing well and is characterized by declining prices and increasing innovation.

<sup>37</sup> F.M. Scherer and David Ross, *INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE* (3<sup>rd</sup> Ed.) at 4-5 (Houghton Mifflin Co. 1990).

<sup>38</sup> *C.f. Tampa Electric Co. v. Nashville Coal Co.*, 365 U.S. 320, 327 (1961) (The "area of effective competition in the known line of commerce must be charted by careful selection of the market area in which the seller operates, and to which the purchaser can practicably turn for supplies. In short, the threatened foreclosure of competition must be in relation to the market affected.")

<sup>39</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 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.

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**Step 3:**        *Identifying the Suppliers in the Market*

a. *FERC's View*

Under FERC's proposed analysis, FERC also asserts that an accurate definition of relevant geographic markets also entails identifying those sellers that can compete to supply a relevant product — *i.e.*, “those suppliers that are able to reach the destination market both economically and physically.” To do this, FERC requires merger applicants to use what FERC describes as the “Delivered Price Test.”<sup>40</sup>

Under FERC's “delivered price test,” FERC considers a firm to be a “true” supplier (*i.e.*, it can economically serve destination markets) only to the extent it has generating capacity that can be supplied and delivered to the market at a price, including paying for transmission and ancillary services needed to deliver power to a destination market, that is no more than 5 percent above the pre-merger market price. FERC proposes to require that a supplier's ability to economically serve a destination market be measured by the generating capacity controlled by the supplier rather than historical sales data. In FERC's estimation, because merger analysis should, to the extent possible, be forward-looking, capacity is a better indicator of future market supply alternatives and therefore information about current or past sellers may not identify those participants whose generation capacity could discipline future price increases. Moreover, reasons FERC, data on sales made in a past environment that was characterized by monopoly and cost-based rates may not be a good indicator of how firms will behave in an environment that is increasingly characterized by generation competition and open access transmission.<sup>41</sup>

FERC proposes to use two generating capacity measures to gauge supplier presence. As a starting point, FERC proposes to use the supplier's own generation capacity with low enough variable costs that energy from it could be delivered to a market, after paying all necessary transmission and ancillary

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The problem with this flawed public policy approach, however, is that it is black-letter law that 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*, *supra* n. 30 at 951.

<sup>40</sup> 63 Fed. Reg. 20,344.

<sup>41</sup> *Id.* at 20,344-45.

service costs (including losses), at a price that is 5 percent or less above the pre-merger market price. The other measure of supplier presence FERC seeks to use is available economic capacity, calculated as economic capacity less the capacity needed to serve native load customers.<sup>42</sup>

Notwithstanding the above, FERC finally does recognize that it must consider the transmission costs that would be incurred in delivering generation services to a destination market. For purposes of the competitive screen analysis, therefore, the NOPR seeks to require applicants to use the maximum tariff rates in public utilities' *pro forma* open access tariffs on file with the Commission. Moreover, this information must be extremely specific (and indeed proprietary) in nature — *i.e.*, FERC requires that for each transmission system that a supplier must use to deliver energy to a relevant destination market, applicants must provide specific data, including the transmission provider's name, the firm and non-firm point-to-point rates as well as the ancillary services rates, loss factors and an estimate of the cost of supplying energy losses. Where tariff rates that are expressed as \$/MW are converted to \$/MWH, applicants would have to explain the conversion. FERC also requires applicants to explain how suppliers are assigned transmission contract paths to the destination markets.<sup>43</sup>

b. *The Legal and Economic Reality*

The exact reasons why FERC's pavlovian insistence that applicant must determine initially the boundaries of a relevant geographic market by defining the number of *purchasers* in a market makes little analytical sense hold just as true for FERC's insistence that applicants also define initially the relevant geographic market by identifying the number of *sellers* in a market. Once again for the economically-challenged, if market structure is analyzed correctly, then the task of having to define the boundaries of the relevant geographic will be the very last step in the analysis. Moreover, *identifying the number of buyers and sellers in a market is not how you define the geographic boundaries of a relevant market*. Indeed, the emphasis should be not so much on exactly *where* sellers sell the relevant products, but *how many* sellers there are — *i.e.*, the *number* of sellers is one of a number of economic characteristics that make up the *structure* of the market, which is in turn affected by a variety of *basic conditions*. This structure then affects firms' *conduct*, which determines the

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<sup>42</sup> *Id.* at 20,345.

<sup>43</sup> *Id.* at 20,346-47.

market's overall *performance*.<sup>44</sup> In other words, the *scope* of the merger is *large*, regardless of whether the number of suppliers is two or two hundred.

Moreover, by attempting improperly to “define” the boundaries of a relevant market based exclusively on the number of suppliers and sellers reveals nothing about the effect of regulatory policies on the structure, conduct and performance of the market. To wit, FERC’s proposed analysis would appear to ignore effectively the (presence or lack thereof) of a working ISO. Similarly, while FERC wants applicants to use the Guidelines’ “5% non-transitory price test,” this test does not take into account the huge amount of distortions imposed by current regulatory policies on a utility’s ability to set or maintain prices unilaterally or in coordination with others.<sup>45</sup>

Third, as argued *supra*, FERC’s exclusive use of short-term variable costs makes little sense because it also fails to take into consideration the role of regulatory intervention on market structure, conduct and performance. Specifically, FERC’s assumption chooses deliberately to ignore the thorny issue of stranded costs. Like it or not, the majority of existing generation capacity is characterized accurately as (a) *sunk* assets that (b) that regulators determined previously to be *prudently* incurred by the utility. To assume otherwise means that FERC *a fortiori* believes that every last red cent of stranded costs is correctly recovered and accounted for and that, therefore, a firm’s fixed costs have absolutely no effect on the end price offered to consumers.<sup>46</sup>

The preceding points unfortunately, however, beg the much larger question: FERC must decide whether the generation market is competitive or not. On one hand, if this market is in fact competitive, then Order No. 888 and ISO’s should ostensibly solve all bottleneck problems and the price of generation is irrelevant. Indeed, the inquiry, as always, must focus on those areas where a firm has the ability to exercise market power successfully and additional entry is unlikely — the transmission grid. The fact that FERC, (1) “consistent with the conservative nature” of the competitive screen analysis, requires applicants to use the maximum tariffed rates in the pro forma open

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<sup>44</sup> See Scherer & Ross, *supra* n. 37.

<sup>45</sup> *Id.* at 7-14.

<sup>46</sup> *C.f.* Williamson, *supra* n. 32 (“It is common to distinguish between fixed and variable costs, but this is merely an accounting distinction. *More relevant to the theory of contracting is whether costs are redeployable or not.*”) (Emphasis supplied.)

access tariffs; and (2) requires applicants to assume that “transmission capacity along transmission paths between suppliers and destination markets that is reserved under a long-term firm transmission contract by suppliers should be presumed to be available to other suppliers unless the capacity is committed to a long-term power transaction” simply adds support to this argument.<sup>47</sup>

Finally, (as if FERC’s analysis wasn’t bad enough), where the regulatory chutzpa really comes into play is FERC’s sheepish acknowledgment that even though it proposes to require applicants to provide a plethora of exact proprietary data, much of this data may lie inconveniently with the firms’ rivals (who, to state it politely, will probably not be too thrilled about releasing their proprietary data to their rivals as well). Never an agency to lack any shame, however, FERC simply instructs merger applicants to ask their rivals for proprietary data any way:

The Commission understands that applicants must depend on publicly- available information regarding transmission capability for systems other than their own, and that some of the information discussed above may not be generally available for all systems. Applicants should file the best available data regarding systems other than their own. However, all of the data discussed in this section regarding applicants’ systems is available to the applicants, and such data must be filed, even if it is not available for all other systems. An accurate representation of transmission conditions on or close to the applicants’ systems, where the merger’s effects are likely to be greatest, is important.

<sup>48</sup>

This regulatory chutzpa is simply exacerbated when FERC asks applicants to provide (and disclose to all parties to the proceeding — protective order or not) historical data that can be used to corroborate the results of the competitive screen analysis.<sup>49</sup> Indeed, while FERC states that it “understand[s] that

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<sup>47</sup> 63 Fed. Reg. at 20,346.

<sup>48</sup> *Id.* at 20,347.

<sup>49</sup> For example, FERC proposes to require applicants to file actual trade data regarding sales and purchases in which applicants participated for the most recent two years for which data are available. Similarly, the NOPR proposes applicants to file detailed information about transmission capability, including a description of all instances in the two years preceding the application in which transmission service on their systems has been denied, curtailed or interrupted. According to FERC, this “description should, to the extent such data are available from OASIS sources, identify the requestor, the type, quantity and duration of service requested, (continued ...)

applicants must depend on publicly-available information for the vast majority of the screen analysis and that some detailed data may not be generally available for all market participants” applicants have to ask for it anyway.<sup>50</sup>

**Step 3:**            *Analyze Concentration Ratios Pre- and Post-Merger.*

a. *FERC’s View*

The final step of FERC’s competitive screen analysis is to use its methodology to calculate and compare market concentration ratios using pre and post-merger HHIs. Once applicants calculate these HHIs, they are then to compare these ratios to the thresholds set forth in the 1992 Merger Guidelines.<sup>51</sup> If the Guidelines’ thresholds are not exceeded and there are “no interventions raising substantial concerns regarding the merger’s effect on competition which cannot be resolved on the basis of the written record,” (the requisite regulatory “fail-safe”), then the Commission would not look further at the effect of the merger on competition. On the other hand, if the HHI statistics exceed the DOJ’s thresholds, then applicants must either propose immediately mitigation measures that would remedy the merger’s potential adverse effects on competition (*i.e.*, the regulatory shakedown)<sup>52</sup> or address the other DOJ merger analysis factors.<sup>53</sup>

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the affected transmission path, the period of time covered by the service requested, the applicants’ response, the reasons for the denial and the reservations or other use anticipated by the applicants on the affected transmission path at the time of the request.” *Id.* at 20,348.

<sup>50</sup> Unfortunately, it is just too frustrating to ask at this point why FERC wants applicants to file historical data when it just stated explicitly in the previous section that historical data is irrelevant.

<sup>51</sup> Basically, these thresholds are: (1) “unconcentrated” markets (HHI below 1,000); (2) “moderately concentrated” (HHI between 1,000 and 1,800), and (3) “highly concentrated” (HHI above 1,800). Mergers in the first category generally raise little policy concern under the Guidelines. Similarly, mergers producing an increase in HHI in moderately concentrated markets producing an increase on more than 100 points also do not raise competitive concerns under the Guidelines; however mergers that produce an increase of more than 100 points in this category do. Finally, mergers in the “highly concentrated” category that produce an increase of even 50 points in the HHI post-merger raise “significant competitive concerns” under the Guidelines and would accordingly warrant further action by the DOJ or FTC.

<sup>52</sup> According to FERC, examples of such measures can include generation divestiture and transmission rate reforms (such as the elimination of pancaked rates) that “broaden the geographic market,” and/or a “properly structured ISO” or other regional transmission entity  
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b. *The Legal and Economic Reality*

As mentioned above, when analyzing the structural characteristics of electricity markets, it is extremely important not to exaggerate the relevance of the Hirschman-Herfindahl Index (HHIs). Given the historical structure and the U.S. electricity industry and FERC's radical, yet unclear, attempts to change this structure, many markets will probably be characterized by the presence of one or more firms with a predominant market share. Under the well-accepted precedent highlighted *supra*, this basic condition alone does not indicate that a market is performing poorly. This is why, FERC's analysis must always move beyond HHIs and toward the evaluation of the elasticities of supply and demand and, in particular, the presence (or lack thereof) of barriers to entry.<sup>54</sup> Just to remind readers once again, *it is black letter antitrust law and economics 101 that market share, in and of itself, does not indicate the ability to exercise market power successfully. Rather, the analysis must always move beyond concentration ratios and toward the evaluation of the elasticities of supply and demand and, in particular, the presence (or lack thereof) of barriers to entry.* If FERC fails to take this required extra analytical step, then it must be reversed as arbitrary and capricious decision-making.<sup>55</sup>

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that "can lower concentration by both eliminating the pancaking of rates and encouraging new entrants." 63 Fed. Reg. at 20,348.

<sup>53</sup> The Guidelines describe four additional factors to examine in situations where merger-induced concentration exceeds specified thresholds: (1) the potential adverse competitive effects of the merger; (2) whether entry by competitors can deter anticompetitive behavior or counteract adverse competitive effects; (3) the effects of efficiencies that could not be realized absent the merger; and (4) whether one or both of the merging firms is failing and absent the merger the failing firm's assets would exit the market. 1992 Merger Guidelines § 0.2.

However, this route does not appear to provide much of an option for applicants. FERC correctly states that the Guidelines suggest that entry must occur within two years of the merger to be considered timely, and that all phases of entry must occur within the two-year period, including planning, design, permitting, licensing and other approvals, construction and actual market impact. *Given the current lead times for bringing new generation or transmission capacity on line, however, FERC concedes that it "may be unlikely that entry can be a mitigating factor unless facilities are already in the planning or construction stages at the time of the application."* 63 Fed. Reg. at 20,348 (emphasis supplied.)

<sup>54</sup> *See generally*, Cameron and Glick, *supra* n. 15 at 193 (legal precedent requiring courts to draw inferences about market power based primarily or exclusively on market shares and/or market concentration can often be misleading; the only alternative to such bright-line rules is to utilize modern economic tools to undertake more extensive competitive analyses).

<sup>55</sup> *See supra* n. 15 and citations therein.

An excellent example of how market shares can be misleading can be found in the Federal Communication Commission's recent decision to reclassify AT&T as a non-dominant carrier for domestic long-distance service.<sup>56</sup> In that proceeding, many parties argued that AT&T had market power simply by virtue of possessing a market share of approximately 60 percent. Upon review, however, the FCC found that while AT&T did in fact have a very large market share, AT&T nonetheless faced a very elastic demand curve, such that consumers were very likely to switch carriers in the event of a price increase or unsatisfactory service. Moreover, the FCC found that not only did AT&T no longer control any bottleneck facilities, but supply was highly elastic both in terms of excess capacity and the number of competing firms. Finally, the Commission found strong evidence of non-price competition in the form of frequent-flyer points, cash incentives, credit cards, and the like. Given such a market structure, the Commission found that it would be difficult for AT&T to successfully engage in strategic conduct to exercise market power.<sup>57</sup>

What is truly incredulous, however, is that not more than five years ago, FERC recognized this very principal as well. In *Entergy*, when an intervenor raised essentially the same argument FERC now attempts to raise *sua generis* in its NOPR, FERC explained in excruciating detail exactly why this argument made absolutely no analytical sense.<sup>58</sup> Specifically, an intervenor argued because the HHIs in certain relevant markets would exceed the acceptable standard set forth in the Merger Guidelines, the proposed merger is presumed to be anticompetitive and therefore the Commission must set the proposed merger's effect on competition for a trial-type hearing. The Commission found this argument "flawed in two important respects." As a preliminary matter, FERC reminded parties that it had "consistently held that, while the Merger Guidelines are a useful analytical tool, the Commission is not bound by them. Rather, the Commission may weigh and balance HHIs with a number of factors to determine whether a proposed merger is consistent with the public interest." Moreover, reasoned FERC, the intervenor "while attempting to use the Merger Guidelines as support, fails to undertake the complete analysis prescribed by the Guidelines." Specifically, that the intervenor "fails to

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<sup>56</sup> *In re Motion of AT&T Corp. to Be Reclassified as a Non-Dominant Carrier*, FCC 95-427, 11 FCC Rcd. 3271 (1995).

<sup>57</sup> *Id.*

<sup>58</sup> *Entergy Services, Inc. and Gulf States Utility Company, Order on Reh'g*, 64 FERC ¶ 61,001, (1993).

acknowledge that the Merger Guidelines provide that monopoly power can be mitigated.” According to the Commission:

Specifically, in order to create an anticompetitive harm, the kind of harm both the Commission and the Guidelines are concerned with, the utility must possess monopoly power in relevant markets. Monopoly power, in turn, generally involves the ability either to profitably maintain prices above competitive levels for a significant period of time, or to lessen competition on dimensions other than price (such as product quality, service or innovation). However, . . . the Merger Guidelines provide that monopoly power can be mitigated, *inter alia*, if entry into the relevant markets is so easy that: “entry would be timely, likely, and sufficient in its magnitude, character and scope to deter or counteract the competitive effects of concern. In markets where entry is that easy (*i.e.*, where entry passes these tests of timeliness, likelihood and sufficiency), the merger raises no antitrust concern and ordinarily requires no further analysis.”<sup>59</sup>

The Commission found, however, that the merging parties’ open-access tariff would make entry this easy. According to FERC,

With the open-access tariff in place, . . . competitors will have immediate access to substantial additional generating capacity otherwise outside the relevant markets. Moreover, the open-access tariff provides access for non-traditional power producers (including QFs and exempt wholesale generators (EWGs)) that generate electric energy for sale for resale.<sup>60</sup>

### **B. FERC’s “Vertical Merger” Analysis**

In FERC’s merger NOPR, FERC also proposes an analytical framework to deal with “vertical mergers.” FERC initially defines “vertical” mergers as those transactions “between electric utilities and firms that provide inputs for

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<sup>59</sup> *Id.*

<sup>60</sup> *Id.*

electricity generation.”<sup>61</sup> When pressed for more specifics, however, FERC is not very forthcoming.

1. *General Framework*

a. *FERC's View*

While FERC finds it easy to identify the “downstream” market (*i.e.*, “the customers potentially affected by the merger and the suppliers that compete with the merging firm”<sup>62</sup>), the Commission fails deliberately to articulate specifically what constitutes the “upstream” market. All we know is that this product market can exist anywhere and consist of those “products produced by the upstream merging firm and used by the downstream merging firm and/or its competitors in the production of relevant downstream electricity products.”<sup>63</sup>

Finally, the NOPR is quite hostile to the notion of vertical mergers in general. Indeed, it almost appears that FERC considers them to be *per se* anticompetitive. For example, FERC makes absolutely no mention whatsoever about the efficiency enhancing characteristics of vertical integration, but instead states matter-of-factly that “vertical mergers do not directly eliminate a competitor from the market but may create or enhance the incentive for the merged firm to adversely affect prices and output in the downstream electricity market. “

b. *The Legal and Economic Reality*

As a preliminary matter, someone needs to point out to FERC that the *per se* rule against vertical integration went out a very long time ago. In *United States v. Arnold, Schwinn & Co.*,<sup>64</sup> the Supreme Court held that vertical resale restrictions were to be viewed under a *per se* analysis. Following a decade of disagreement as to the scope and meaning of *Schwinn's* pronouncement,

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<sup>61</sup> 63 Fed. Reg. at 20,349.

<sup>62</sup> *Id.* at 20,351.

<sup>63</sup> Moreover, FERC fails to differentiate significantly between “vertical” mergers (*i.e.*, mergers that ostensibly affect multiple steps for the production and sale of electricity) and “hybrid” mergers between gas and electric utilities. *See, e.g., id.* at 20,353.

<sup>64</sup> 388 U.S. 365 (1967).

however, the Supreme Court in *Continental TV, Inc. v. GTE Sylvania, Inc.*, 433 U.S. 36 (1977), specifically overruled the *per se* rule announced in *Schwinn* and directed a return to a rule of reason analysis for evaluating vertical non-price restrictions. *Sylvania* marked the rise of the Chicago School, with its view that because vertical restraints usually create efficiencies and do not restrict output, those restraints should generally be lawful.<sup>65</sup> The more some more recent literature takes a middle ground, however, arguing that while vertical restraints can create economic efficiencies, the possible anticompetitive effects should not be summarily dismissed without careful examination.<sup>66</sup>

Accordingly, as a general economic matter, *there is absolutely nothing wrong will vertical integration in and of itself*. Vertical integration can allow a firm to realize many economies of scale and scope.<sup>67</sup> These benefits can include, but certainly not be limited to:

- (1) Economies of scale and scope;
- (2) Eliminating free-rider problems;
- (3) Spreads risk of investing/losing sunk costs;
- (4) Coordination in design and production; and
- (5) Eliminates double mark-up of costs.<sup>68</sup>

The fact that FERC chooses to ignore these benefits, however, does not mean they do not exist. What FERC needs to focus on — but unfortunately and conspicuously does not — are those specific situations *where the economic costs of vertical integration outweigh the efficiencies gained from such integration*.<sup>69</sup>

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<sup>65</sup> See, e.g., Robert H. Bork, *THE ANTITRUST PARADOX* 303 (1978).

<sup>66</sup> See, e.g., Michael H. Riordan & Steven C. Salop, *Evaluating Vertical Mergers: A Post-Chicago Approach*, 63 *ANTITRUST L.J.* 513 (1995); Lawrence A. Sullivan, *Section 2 of the Sherman Act and Vertical Strategies by Dominant Firms*, 21 *SW. U. L. REV.* 1227 (1992).

<sup>67</sup> See, e.g., *In Re Applications of Capital Cities/ABC, Inc., (Transferor) and The Walt Disney Company, (Transferee)*, Memorandum Opinion & Order, 11 F.C.C.R. 5841 (rel. Feb. 8, 1996).

<sup>68</sup> See also Olson & Spiwak, *supra* n. 27 at 291.

<sup>69</sup> *Id.*; see also *Second Edition* at 44 & n. 114 (citing, *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 F.M. Scherer and David Ross, *supra* n. 37 at 5 (“Despite antitrust’s focus on structural measures such as the HHI, economic concentration is only one aspect of market structure. Other relevant features of market  
(continued . . .)

## 2. *Purported Harms and Remedies of “Vertical” Integration*

FERC cites three potential anticompetitive harms that could be produced by vertical integration: (1) foreclosure/raising of rivals’ costs; (2) facilitating coordination; and (3) evasion of regulation. FERC’s analysis of each potential harm is critiqued individually below:

### a. *Foreclosure/Raising Rivals’ Costs:*

#### i. *FERC’s View*

~~The Purported Harm.~~ According to FERC, a merger between an entity owning downstream electric generation and an entity owning an upstream input supplier to competitors of that generation may create the incentive for the upstream firm to exclude the merged firm’s downstream generation competitors from access to inputs. The upstream merging firm can accomplish this through pricing, marketing and operational actions that would raise the input costs of suppliers competing with the downstream merging firm or by otherwise restricting such suppliers’ input supply. This behavior can also deter entry by rival generators in the downstream market.<sup>70</sup>

FERC asserts that a vertical merger can create or enhance the ability of the merged firm to adversely affect electricity prices or output in the downstream market by raising rivals’ input costs if both the “upstream and downstream geographic markets are susceptible to the exercise of market power.” (e.g., in the upstream market, generators purchasing from the upstream merging firm could not turn to alternative suppliers to avoid an increase in input prices; in the down stream market, the merging firm’s customers could not turn to alternative electricity suppliers to avoid an increase in electricity prices.)

~~FERC’s Proposed Remedy.~~ Assuming *arguendo* that *both* the upstream and downstream markets are conducive to the exercise of market power, then FERC would require merger applicants to demonstrate affirmatively that raising rivals’ costs would be “*difficult*, even if the merger creates or enhances the ability of the merged firm to adversely affect prices or output in the downstream market.” For example, FERC proposes that applicants should

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structure include product differentiation, barriers to entry, cost structures, vertical integration, and diversification.”)

<sup>70</sup> 63 Fed. Reg. at 20,349.

provide adequate information (naturally, supported by data and documentation), regarding how the merged firm could raise its rivals' costs, including, but certainly not limited to: (1) outlining the types of products or services sold by the upstream firm to each downstream competitor; (2) revealing the terms of contracts under which products or services are sold and the duration of such contracts; (3) providing exact descriptions of the prices, availability quality and input delivery points of inputs sold to downstream competitors; and (4) providing detailed information about generation unit scheduling, impending technological improvements, and marketing that is provided by customers to the upstream firm, "*particularly any market-sensitive information that may be subject to confidentiality provisions.*"<sup>71</sup> Similarly, although FERC recognizes that a raising rivals' costs strategy is unlikely to harm competition unless such behavior is profitable, in order to ferret out anticompetitive evil everywhere, FERC would also require applicants to "*provide data and documentation supporting an assessment of the profitability of a raising rivals' costs strategy if this data could materially affect a conclusion that a proposed merger could harm competition.*"<sup>72</sup>

ii. *The Legal and Economic Reality*

As mentioned above, it is extremely difficult to discern exactly what product and service markets should be permitted to, or prohibited from, integrating in the first instance. To wit, is FERC talking about mergers between gas pipelines and generating companies, such that if there are no alternative sources for the rival's key input of production — *i.e.*, fuel to run its generators? If so, regulatory intervention might be appropriate to remedy a classic case of potential input foreclosure may be present (*i.e.*, absent effective safeguards, the merged entity would have *both* the incentive *and* the ability to engage in undue price or non-price discrimination against its rivals). Similarly, what if the merging companies did not own any generation at all, but nonetheless controlled bottleneck facilities?<sup>73</sup>

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<sup>71</sup> *Id.* at 20,352 (emphasis supplied).

<sup>72</sup> *Id.* (emphasis supplied).

<sup>73</sup> What is particularly interesting to note is that FERC refuses deliberately to acknowledge the most common of input foreclosure theories: the "price squeeze" doctrine. Why? Because courts have consistently found (with one limited exception) that the structural characteristics of the U.S. electric utility industry make it essentially impossible for firms to engage successfully in such behavior. Refusing to acknowledge this precedent does not mean that FERC may now suddenly "reinvent" a brand new "alternative" theory to attack and "restructure" historical  
(continued ...)

Alternatively, is FERC talking about vertical integration among suppliers of generation and transmission/distribution facilities? If so, then under FERC's flawed understanding about the law and economics of vertical integration discussed *supra*, then the entire U.S. electric utility industry since its very inception has been *per se* unlawful as well — any efficiencies be damned. If FERC is uncomfortable with this structure, it is for Congress to change — not FERC by regulatory fiat. As mentioned above, however, this has not deterred FERC from doing indirectly what it cannot do directly, given FERC's current all-out campaign to abrogate every long-term contract in an improper effort to “level the playing field.”<sup>74</sup> Moreover, what about the effect of ISOs on the ability to constrain the owners of bottleneck facilities to exercise successfully against potential rivals? Likewise, what about a “vertical” merger between an energy marketer and generator that did not involve any transmission at all?

For these reasons, FERC must define exactly what the specific foreclosed input it is worried about. Moreover, not all input foreclosure raises *a fortiori* anticompetitive concerns either. Twenty years ago, George Stigler attempted to define in economic terms, exactly what inputs, if foreclosed, would be a true barrier to entry. In Stigler's view, those inputs are costs of production “which must be borne by a firm which seeks to enter an industry but is not borne by firms in the industry.”<sup>75</sup> Subsequently, Christian von Weizsäcker proposed a slightly more narrow definition of a barrier to entry that qualifies slightly Stigler's — *i.e.*, those costs of production “which must be borne by a firm that seeks to enter an industry but is not borne by firms already in the industry and which implies a distortion in the allocation of resources from the social point

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industry market structure. For a further explanation of this topic, see Lawrence J. Spiwak, *Is the Price Squeeze Doctrine Still Viable in Fully-Regulated Energy Markets?* 14 ENERGY L.J. 175 (1993).

<sup>74</sup> See John Berresford, *Future of the FCC: Promote Competition, Then Turn Out the Lights?* 21-22 (Economic Strategy Institute, May 1997). Berresford states that 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.”

<sup>75</sup> George Stigler, *THE ORGANIZATION OF INDUSTRY* at 67 (1968).

of view.”<sup>76</sup> In other words, whenever government proposes to remove a purported barrier to entry, it must conduct a cost benefit analysis that identifies all gains in economic efficiency, including relevant externalities, that are derived from the presence of the entry as well as the actual or potential losses in economic efficiency resulting from the entry barrier, including all costs implied in eliminating or minimizing its effects. Accordingly, FERC’s proposed “zero-tolerance” policy — without important qualifications — is unlikely to be optimal.<sup>77</sup> Again, not all impediments require some sort of government intervention or remediation — only those barriers that are “policy-relevant barriers to entry.”<sup>78</sup> Making applicants file voluminous data to disprove hypothetical, “ephemeral possibilities” by revealing confidential and proprietary business plans does not contribute to this process, however.<sup>79</sup>

b. *Facilitating Anticompetitive Coordination:*

i. *The FERC View*

In FERC’s view, “vertical” mergers can also facilitate anticompetitive “coordination” in either the upstream or downstream markets if, in either case, the merger: (1) creates or enhances the ability of competing firms to agree to raise prices or restrict output or (2) dampens the incentive for firms to compete aggressively on price or service. In addition, argues FERC, anticompetitive coordination can be increased if information, useful for coordinated behavior

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<sup>76</sup> C.C. von Weizsäcker, *A Welfare Analysis of Barriers to Entry*, 11 BELL J. ECON. 400 (Autumn 1980).

<sup>77</sup> *C.f. Williamson, supra* n. 32.

<sup>78</sup> *See supra*.

<sup>79</sup> If you really think about this, FERC’s request is truly incredulous. Basically, FERC (a.k.a. the United States Government) is asking merger applicants *to affirmatively think up and present for regulatory review* various ways to screw their competitors. Moreover, if FERC concludes that the applicants’ proposals won’t be successful (*i.e.*, anticompetitive), then FERC staff will help applicants to go over their submissions and either: (a) offer applicants constructive hints on how to do it better; and/or (b) instruct the applicants to go back to the drawing board to come up with some fresh ideas. And as if this isn’t bad enough, if this collusive public/private sector partnership fails to come up with a “profitable” (*i.e.*, anticompetitive) way to harm the competitive process, FERC nonetheless provides the applicants with a lovely consolation prize — innovative ways to mess with competitors’ businesses that applicants (rather than consumers) will initially have to bear the direct costs for but nonetheless harm long-term consumer welfare by encouraging inefficient (indeed stupid) behavior. While I know that government is supposed to be there to help me, this proposal is ridiculous. Indeed, FERC’s proposal simply takes the concept of “regulatory capture” to a whole new level.

and not available elsewhere, must be shared between the upstream firm and its customers, and there are substantial transactions between the upstream merging firm and non-affiliated customers.

ii. *The Legal and Economic Reality*

Once again, FERC should refer to the economic literature and legal precedent before requesting comment on outright erroneous assertions of economic first principles. In particular, it is wholly unclear why FERC's primary discussion about possible collusive behavior first appears in the *vertical* section. Collusion is likely to occur in highly concentrated oligopolistic markets —*i.e.*, a horizontal issue. Moreover, what kind of collusion is FERC concerned about? Clearly, if discovery reveals a “smoking gun” demonstrating overt collusion, then the inquiry is at its end. However, what happens when no smoking gun is found, but there is a clear pattern of parallel pricing? Is it evidence of joint-profit maximization (and should therefore properly be a violation of the antitrust laws) or is it simply Cournot pricing (and therefore not a violation)?<sup>80</sup>

Because these are complex econometric problems, FERC simple cannot make broad-brush assertions about very serious issues. By doing so, it simply “poisons the well” and creates the misguided incentive to hunt for the “bogeyman” rather than conduct a thorough analysis. Indeed, the ability to make an accurate determination of firms' conduct will depend directly on the accurate identification of the market's basic conditions and structure referenced above. Specifically, are there homogenous products? Are supply and demand elastic? How sophisticated are consumers? And is there an adequate signaling mechanism? If the structure of the market indicates pro-competitive conditions – *i.e.*, high elasticities of supply and demand, sophisticated consumers, no asymmetrical or advanced tariffing requirements to act as price signals, *etc.* – then firms will probably not be able to succeed in strategic conduct, even if they try.<sup>81</sup>

To wit, in yet another glaring example of regulatory chutzpa, FERC refuses deliberately to admit that the flawed economics contained in are the direct cause of many of the harms it claims it wants to mitigate. For example,

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<sup>80</sup> See, *e.g.*, *E.I. Du Pont v. FTC*, 729 F.2d 128, 139 (2d Cir. 1984)(three or four substantial rivals are enough to preserve competition even under the “ideal” conditions for collusion); *Market Force, Inc. v. Wauwatosa Realty Co.*, 906 F.2d 1167, 1172 (7th Cir. 1990)(“[C]onscious parallelism by itself is not enough to support an antitrust conspiracy case.”); *Clamp-All Corp v. Cast Iron Soil Pipe Institute*, 851 F.2d 478, 484 (1st Cir. 1988), *cert. denied*, 488 U.S. 1007 (1989); *City of Tuscaloosa et al. v. Harcros Chemicals, Inc.*, 877 F. Supp. 1504, 1524 (N.D. Ala. 1995); see also, Louis Philips, *THE ECONOMICS OF IMPERFECT INFORMATION*, Chapter 6 (Cambridge University Press 1988).

<sup>81</sup> See generally, *Brooke Group Ltd.*, *supra* n. 69.

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>82</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>83</sup> Moreover, not only does FERC require nearly everybody to post their price and service offerings, but these price and service offerings must be *homogeneous* as well. Aside from probably violating the *Mobile-Sierra* doctrine, it is very unclear how mandated homogeneity will result in 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>84</sup> And, certainly not least, if there is any shred of complexity left to mitigate the ease with which firms might be able to successfully engage in collusive behavior, as discussed *supra*, FERC proposes to eviscerate it by requiring everyone to reveal their proprietary information *and* asking everyone else to please do the same.

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<sup>82</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>83</sup> *See generally*, Phillip Areeda & Herbert Hovenkamp, ANITRUST LAW: AN ANALYSIS OF ANITRUST 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.”

<sup>84</sup> *See FERC Chair Hoecker Delivers Scary Halloween Message for Industrials*, FOSTER ELECTRIC REPORT, No. 125 (Nov. 5, 1997).

c. *Regulatory Evasion:*

i. *The FERC View*

~~The Purported Harm.~~ Finally, FERC asserts that potential for vertical mergers involving jurisdictional electric utilities also raise the potential for firms to engage successfully in regulatory evasion. For example, argues FERC, after merging with an upstream input supplier, a downstream electric utility's input purchases would be "internal" to the firm. The merger, therefore, could create the incentive for the merging upstream input supplier to inflate the transfer prices of inputs sold to the downstream regulated utility to the extent it can evade regulatory scrutiny. According to FERC's logic, because profits would increase for the vertically-integrated firm as result of such a strategy but would accrue only to the "unregulated affiliate," higher electricity prices could result from such a strategy.

~~Proposed Remedy No. 1: Proposed Requirements for Ratepayer Reductions.~~ In the past, FERC has not hesitated to impose stringent "ratepayer protection mechanisms" (*i.e.*, regulatory shakedowns) ostensibly to protect the wholesale customers of merger applicants (*e.g.*, open seasons to allow early termination of existing service contracts or rate freezes) if the contemplated benefits of the merger do not materialize. Keeping with tradition, therefore, FERC proposes to require all merger applicants to demonstrate "how wholesale ratepayers will be protected" and, moreover, how their "proposed ratepayer protections are adequate."<sup>85</sup>

~~Proposed Remedy No. 2: Requirements Concerning the Impact on State and Commission Regulatory Jurisdiction.~~ As explained in more detail *infra*, FERC, unfortunately, has developed a recent habit of expanding its jurisdiction into areas that are clearly beyond its statutory mandate. It should come as no surprise, therefore, that FERC attempts to extend and codify its jurisdictional conquests in its merger NOPR. For example, FERC proposes to continue to require that, for all merger applications involving public utility subsidiaries of registered holding companies, applicants must either commit to abide by the Commission's policies with respect to intra-system transactions within the holding company structure or be prepared to go to hearing on the issue of the effect of the proposed registered holding company structure on effective regulation by the Commission. Similarly, for those mergers that where the affected state lacks authority over the merger but nonetheless raises concerns

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<sup>85</sup> 63 Fed. Reg. at 20,353.

about the effect on regulation, FERC will gladly step in to fill the regulatory vacuum.<sup>86</sup>

ii. *The Legal and Economic Reality*

Any legitimate critique of the preceding section requires FERC to answer one very simple question: Specifically, when FERC talks about an “unregulated affiliate,” does this mean the firm is not subject to *any* public utility regulation, or just that *FERC* does not impose specifically any regulation on the firm at the time of the merger application? If the former, then it is a question of regulatory failure, not regulatory evasion.<sup>87</sup> If the latter, then readers must be made aware of FERC’s long and distinguished history of imposing mandatory safeguards (“voluntary” or otherwise) that go far beyond any demonstrable nexus to a specific, merger-related harm.

For example, take the case of FERC’s proposed requirement that applicants essentially have a pre-determined “protection” mechanism (*a.k.a.*, bribe) for large wholesale requirements before they even walk through the door at 888 First Street. Once upon a time, FERC recognized accurately that because its Section 203 authority is limited with remedying the specific anticompetitive harms directly resulting from the proposed merger, that there must be a direct nexus between the proposed merger, the alleged anticompetitive harm, and the remedy imposed.<sup>88</sup> Unfortunately, however, because FERC once again realized that it could use its Section 203 authority to advance its “neo-competitive” agendas without repercussion,<sup>89</sup> FERC over the last several years has engaged in a systematic “shakedown” of every merger applicant who has walked

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<sup>86</sup> *Id.*

<sup>87</sup> See, e.g., DOJ Comments at 10 (Regulatory evasion is unlikely because “with state and federal regulation, any monopoly rents would be passed back to native-load customers.”); *Utility Entry* at 53-58.

<sup>88</sup> The “direct nexus” test is perhaps former FERC Commissioner Charles Trabant’s greatest contribution to FERC jurisprudence. See, e.g., Opinion No. 318, *Utah Power & Light Company, et al.*, 45 FERC ¶ 61,095, at p. 61,282 (1988), Opinion No. 318-A, *Utah Power & Light Company, et al.*, 47 FERC ¶ 61,209, at pp. 61,736-37 (1989); Opinion No. 364, *Northeast Utilities Service Company (Re: Public Service Company of New Hampshire)*, 56 FERC ¶ 61,269, at p. 62,012 (1991).

<sup>89</sup> See Frank Easterbrook, *The Court and the Economic System*, 98 HARV. L. REV. 4, 39 (1984) (“[A]n agency with the power to deny . . . or to delay the grant of [an] application . . . only if the regulated firm agrees to conditions . . . is a potent way to greatly increase the span of the agency’s control.” (emphasis supplied)).

though the door.<sup>90</sup> What is particularly egregious, however, is that FERC has nakedly attempted to benefit and protect one class of large, sophisticated customers at the expense of American consumer welfare as a whole<sup>91</sup> — even

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<sup>90</sup> For example, in *El Paso Elec. Co. and Central and South West Servs. Inc.*, 68 F.E.R.C. (CCH) ¶ 61,181 (1994), FERC concluded that the “national interest” was to establish a “competitive bulk power market” and that it would, therefore, “be a *detriment to the national interest* to allow mergers or consolidations that do not offer comparable transmission access,” FERC held that it could no longer “find *any newly filed merger* consistent with the public interest if the merging public utilities do not offer comparable services, *whether or not that merger results in an increase in market power.*” (Emphasis supplied.) Unfortunately, because the “voluntary” commitments imposed by FERC essentially made the deal uneconomical, the parties subsequently abandoned the transaction which, naturally, resulted in years of costly litigation. Similarly, in *Ohio Edison Co. et al.*, 80 F.E.R.C. ¶ 61,039 (1997), FERC gave merger applicants Faustian regulatory choice of either proceeding directly to a trial-type evidentiary hearing (*i.e.*, regulatory delay) or proposing “measures to potential market power problems” (*i.e.*, make competitors, rather than consumers, better off) such as limiting internal transmission capability for other suppliers’ use (*i.e.*, sacrifice its own system reliability for rivals’ benefit) or building new transmission systems, *not for its own needs, but to* “substantially increase the amount of power than can be delivered to destination markets from alternative suppliers” (*i.e.*, if you don’t have enough capacity to sacrifice to rivals without causing major power outages, then you must build this capacity for them) *without either conducting a thorough economic analysis or discussing one potential off-setting efficiency benefit of the merger.* *But cf.* *Entergy Servs., Inc. & Gulf States Utils. Co.*, 64 F.E.R.C. ¶ 61,001 (1993), where FERC specifically declined to impose “network” service as a condition (voluntary or involuntary) of a merger. According to FERC, its conditioning authority should be appropriately limited to “*remedying anticompetitive harms that result directly from the proposed merger, not mere competitive disadvantages that may have existed prior to the merger.*” because it was expressly “*prohibited from conditioning a merger to affirmatively place competitors in a better position than they would be absent the merger without a showing of potential anticompetitive or other harm that would warrant a remedy.*” Absent a clear “nexus between the merger application and the alleged anticompetitive harm, if any, to the complainant,” therefore, FERC held that if it “ordered network service as a condition of the merger, *[then it] would not be maintaining the competitive status quo as [it is] legally required to do under section 203(a) of the F.P.A., but would, in fact, be changing the competitive status quo*” and, as such, would exceed its statutory authority to impose conditions. (Emphasis supplied and citations omitted.)

<sup>91</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); Cam Simpson, *Merger Mania Has Awakened Utility Industry*, THE INDIANAPOLIS STAR/INDIANAPOLIS NEWS, Feb. 3, 1997; Margie Hyslop, *Electricity Dereg May Not Lower Rates*, Montgomery J., June 4, 1997, at A1; Agis Salpukas, *Utility Deregulation: Boon or Boondoggle?*, N.Y. TIMES, Feb. 1, 1997, at Section D; Peter Coy, *Utilities: Prognosis 1997*, BUSINESS WEEK, Jan. 13, 1997, at 118; Hiram Reisner, *Big Business Wins, Homeowners Lose Louisiana Competition Study Shows*, ELECTRIC UTILITY BUSINESS & FINANCE, Oct. 7, 1996, at 2 (“In terms of the economy as a whole, the benefits of expected lower prices for industrial customers do not offset the reduction in disposable income due to higher residential rates.” As such, the state should expect to see “*an overall reduction in personal income, retail sales, tax revenues, and economic output*” (emphasis supplied)); see also *Utility Entry into Telecommunications*, *passim*.

when (in FERC's own words) additional regulation will be unnecessary because "customer protection is increasingly dependent on vibrant competition."<sup>92</sup>

Similarly, FERC's attempts to seek "economic-type" cover for naked jurisdictional land-grabs are especially specious in light of FERC Chair Jim Hoecker' brazen admission that the goal of FERC's merger review process is not to maximize consumer welfare, but to maximize improperly *regulatory efficiency* instead.<sup>93</sup> Moreover, the fact that FERC has expanded improperly to cover transactions involving everything from mergers among registered public utility holding companies<sup>94</sup>, mergers among Wall Street investment brokerage

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<sup>92</sup> Marvin T. Griff, *What's New About the FERC's New Utility Merger Policy: Applicants can only Hope that a Prompt Review Won't be even More Difficult*, PUBLIC UTILITIES FORTNIGHTLY ((Feb. 1, 1997) at 16, 20 & n. 13.

<sup>93</sup> 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>94</sup> *Illinois Power*, 67 FERC (CCH) ¶ 61,136 (1994); see also Griff, *supra* n. 92 at 21:

Parties who are anxious to secure prompt approval of merger applications [involving registered public utility holding companies], without the bother and expense of a trial-type hearing, will readily be coerced into conceding to the FERC denied by law it was under *Ohio Power*. All the same, that concession will stem from coercion, not from law. However well intended, this new policy will place the FERC in a position undesirable for an agency of a democratic government.

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 Clinton Administration is finally agrees with me that Congress should close the regulatory loophole between SEC and FERC merger review. See Clinton Electric Competition Plan 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.

houses<sup>95</sup> the operator of an computer-automated information exchange for sellers and buyers of electricity<sup>96</sup>, and the entire Canadian electric utility industry,<sup>97</sup> the notion that FERC thinks that Jell-O is also jurisdictional under the FPA might not be too far away.<sup>98</sup>

### III. Conclusion

As argued in the beginning of this paper, it makes little sense to criticize FERC's proposed merger analysis in the abstract, because FERC's merger NOPR is simply yet another symptom of a much larger malaise that is slowly killing the fragile corpus of consumer welfare. Indeed, FERC's transparent attempt to show Congress, the industry, and consumers at large that it too can conjugate the verb "to compete" in the same sentence as the word market by using a Merger Guidelines-style analysis and antitrust "buzzwords" does not change the sad fact that it is, in fact, continuing to use unlawfully the concept of competition as 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. So long as the American public permits FERC unfettered discretion to continue to disregard blatantly (or, to use current

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<sup>95</sup> *Morgan Stanley Capital Group, Inc.*, 79 FERC (CCH) ¶ 61,109 (1997).

<sup>96</sup> *Automated Power Exchange, Inc.*, 82 FERC (CCH) ¶ 61,287 (1998).

<sup>97</sup> *Promoting Wholesale Competition Through Open-Access Non-Discriminatory Transmission Services by Public Utilities*, 79 F.E.R.C. ¶ 61,367 (1997) ("[P]ublic interest" did not favor granting Ontario Hydro's request for stay of reciprocal "open-access" transmission tariff requirement because "a stay would unfairly permit Canadian utilities to compete in U.S. markets, but deprive U.S. utilities of the opportunity to likewise compete in Canadian markets. This unequal treatment could detrimentally affect the financial well-being of U.S. public utilities").

<sup>98</sup> *Utility Entry* at 45 & n. 111. For example, FERC seeks comments on:

new kinds of mergers that may lead to the blurring of traditional utility services and other business lines. Should our market concentration analysis extend to new products that may result from such a convergence of business lines, even if these products are principally concerned with end-use markets? For example, a combination involving a public utility and a telecommunication business could offer new products and services, such as sophisticated interactive electric metering, real-time pricing, automatic utility control of customer machinery and appliances to minimize electricity costs, and computerized shopping for the most economical power supplier. Are our proposed vertical merger filing requirements adequate for review of this form of public utility merger, to the extent such mergers are jurisdictional? 63 Fed. Reg. at 20,353.

The answer to FERC's inquiry should be a resounding "NO." FERC has done far too much already to discourage utility entry into telecommunications. See *Utility Entry passim*.

parlance, “re-invent” or “move beyond”) basic economic first principles and legal precedent, it is very unlikely that FERC’s 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. It is therefore incumbent upon all of us to remind FERC again and again *and yet again until it hurts* 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>99</sup>

Perhaps Judge Frank Easterbrook summed it up best over ten years ago.

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.*<sup>100</sup>

Certainly words to live by.

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<sup>99</sup> *The Search for Meaning* at 2-5; 9-19.

<sup>100</sup> *Easterbrook*, supra n. 88 at 40 (emphasis supplied).