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ANTITRUST SHOULD PROMOTE COMPETITION ON TOP OF WELL-REGULATED INFRASTRUCTURE PLATFORMS

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AND
CONSUMERS UNION

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INTRODUCTION

My name is Mark Cooper. I am Director of Research at the Consumer Federation of America. I appear today on behalf of the Consumer Federation of America[1] and Consumers Union.[2] We appreciate the opportunity to offer our views on the role of antitrust in regulated industries.

Our organizations have been actively involved at the intersection of antitrust and regulated industries for more than two decades. We have participated in virtually every major telecommunications, cable TV and mass media merger proceeding at the Federal Communications Commission and many state public utility commission proceedings during the merger wave unleashed by the Telecommunications Act of 1996. We have also participated in several of the major regulatory restructuring proceedings affecting electricity and natural gas utilities at the Federal Energy Regulatory Commission.

In order to understand the role of antitrust in regulated industries, I believe one must start with an appreciation of why these industries are regulated in the first place.

WHY INFRASTRUCTURE INDUSTRIES ARE (AND SHOULD BE) REGULATED

These are industries in which there is a high probability that unregulated competitive markets will not produce the outcome that society wants. There are two ways this can come about.

- First, where there is market failure, the market will not produce an efficient outcome.

[1] Consumer Federation of America (CFA) is the nation's largest consumer advocacy group, composed of two hundred and eighty state and local affiliates representing consumer, senior, citizen, low-income, labor, farm, public power and cooperative organizations, with more than fifty million individual members. CFA is online at www.consumerfed.org.

[2]. Consumers Union (CU), publisher of Consumer Reports, is an independent, nonprofit testing and information organization serving only consumers. CU is online at www.consumersunion.org.

- Second, there are industries where efficiency is not the only or the most important outcome.

Market failure covers a variety of issues, but I want to focus on the important causes of market failure that cannot be addressed by the efforts of antitrust authorities to protect and promote competition. In these cases supply-side fundamentals mean that we will not be able to rely on competition between a sufficient number of suppliers to promote social welfare.

Classic public goods characteristics and economies of scale (as well as other barriers to entry) mean that the number of competitors is likely to be very small. While natural monopoly has been the most frequent case, various forms of regulation, such as common carriage, have been imposed in weakly competitive situations.

A more fundamental market failure arises where the industry exhibits infrastructural externalities. By that I mean these industries support a wide range of activities and the external benefits are indirect and diffuse. This also means that there are many complementary activities and vertical linkages to other sectors in the economy. These industries are frequently networks and exhibit strong network effects. In contemporary terminology, they are called platforms.

In these cases, private actors cannot identify or internalize the value to society created by these projects. Simple microeconomic calculations may not fully capture the economic structure and value of these sectors and private actors are very likely to under-invest or not invest at all. Transportation, communications and energy delivery have been frequent areas where these characteristics are in evidence.

- Public policy has rightly concluded that these sectors are "affected with the public interest" and

- it has defined the public interest broadly to reflect the broad and diffuse impact of these sectors on the economy and society.

On the demand side, regulation has frequently been applied where there are few substitutes. The price elasticities of demand in these sectors are low. They are frequently necessities, where the income elasticity of demand is larger than the price elasticity of demand, but not very large. The ability to exercise market power is magnified under these conditions. Again, the transportation, communications and energy delivery sectors exhibit this characteristic.

Regulation has also frequently been applied where the product of the industry has important non-economic aspects, like electronic speech, or a non-efficiency aspect, such as universal service or public safety. To put it simply, antitrust has come to be about efficiency; it does not do democracy or equity or public safety very well. Some argue that antitrust once had these broader purposes and still should. Be that as it may, as currently practiced, antitrust is narrowly focused on economic efficiency and competition.[3]

- It is fundamentally incorrect to assume that all regulated industries are in some stage of a transition to deregulation.
- There are simply some sectors where market forces are insufficient to allow deregulation and some where efficient market outcomes are not all that society wants.

The former point can be underscored by a recent reconsideration of electricity restructuring by the Cato Institute, a very free market-oriented think tank.[4] In November 2002, I participated in a debate on Capitol Hill sponsored by the Cato Institute entitled *Too Much Deregulation or Not Enough,* at which my opponent was Peter Van Dorn, Cato's

[3] Indeed, some would argue that it has become too focused on efficiency claims at the expense of competition (see for example, Adams, Walter and James W. Brock, *The Bigness Complex* (Stanford University Press, Stanford: 2004).

[4] Taylor, Jerry, and Van Doren, Peter. (2004). *Rethinking Electricity Restructuring.* Washington: Cato Institute.

director of regulatory analysis.[5] It was one of many such debates over the course of several years, some of which became quite heated. At one point, my arguments against deregulation of electricity were characterized as "East German economics"[6]

Two years later, Cato flip-flopped in a paper entitled *Rethinking Electricity Restructuring*. Cato discovered that this is not a matter of East German versus US economics; it is a question of empirical economics.[7]

> In regulated markets, it is usually quite easy for economists to demonstrate that consumers do not benefit from regulation, but unlike many other markets, electricity markets have characteristics that are difficult to manage through property rights and contracts. Accordingly, regulation has at least the possibility of a plausible rationale.[8]

A collection of analyses published primarily after the implementation of electricity restructuring provided the empirical basis for my opposition to deregulation of electricity and the key to understanding why Cato felt compelled to rethink restructuring.[9]

Cato has discovered that the grid is a public good. In economic jargon, it provides the stage for a comedy of the commons.

> Power added by any generator on an AC transmission system follows all paths but favors those with least resistance rather than the shortest distance between generator and customer. Thus, bilateral contracts between any willing seller and buyer of electricity affect all other buyers and sellers within each interconnected system in ways that are not captured by prices—the textbook definition of externality (6).

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[5] November 1, 2002.

[6] In a subsequent interview on C-SPAN where I debated Jerry Taylor.

[7] This section draws on Cooper, Mark, "Too Much Deregulation or Not Enough," *Natural Gas and Electricity*, June 2005

[8] Ibid., p. 6.

[9] For example, see Cooper, Mark, "Recognizing the Limits of Markets, Rediscovering Public Interest in Utilities," in Robert E. Willett (ed), *Electric and Natural Gas Business: Understanding It! (2003 and Beyond)* (Houston: Financial Communications: 2003).

> Moreover, transmission additions confer benefits across all generators and consumers on the grid and thus have public good characteristics. The development of property rights and prices that internalize those characteristics is very difficult. (6)

Demand elasticity is extremely low.

> Market forces, it was hoped, would introduce marginal-cost pricing and as a result reduce peak demand, increase off-peak demand, and reduce the needless political fighting (most notably, the eternal fight over more supply versus less demand) that inevitably arises in electricity markets because of the absence of prices as a signaling device. (3).

> Even though demand does respond to price, many observers have concluded that demand responsiveness is too low, and, therefore, price spikes would be too high for too long in a truly deregulated environment with tight supplies.

Cato has discovered the problem that utility assets create because of their long-term fixed nature. The problem that results is one that frequently afflicts common pool resources, a tragedy of the anti-commons:

> [I]n an unregulated world, the relations between electric firms and consumers would likely be governed by long-term contracts because the dedicated nature of electricity assets implies that each side can "hold up" the other.

> In short, the weakness of the private solution is the inability of investors to capture the full benefits of their investment. (7)

Supply-side scarcity rents are extreme in this industry:

> In unregulated electricity markets, then, marginal sources of electricity – such as high cost generators typically in operation only during the peak-demand periods – would need to earn at least a normal return. That implies that those facilities with lower marginal costs whose supply is limited… would receive payments in excess of marginal cost (and a normal return) in an unregulated market. (5)

> If we are correct, this implies that gains to trade not occurring under the current balkanized system are much smaller than many observers believe. Accordingly, the fight between the old regime and a restructured regime (that is, the case for a transmission-intense versus balkanized system) is a fight about wealth rather than efficiency. (6)

Electricity is a distinctive service, because of the physics of electrons, but these characteristics are not unique. The Internet and radio spectrum, two communications media, exhibit strong externalities and public goods characteristics in the flow of data.[10] Similarly, the "eternal fight over more supply versus less demand" in communications networks is frequently best resolved by adding capacity rather than allocating scarcity. In communications sectors it is difficult to decide who benefits (how to allocate costs) due to the two-way nature of communications, the strength of direct and indirect network effects, and the infrastructural nature of communications services.[11]

ANTITRUST KEEPS REGULATION IN ITS PROPER SPHERE

These characteristics of regulated industries lead to specific observations on antitrust policy. Given the nature of these industries, the primary regulator is not the market and the role of antitrust is different. There are good public policy reasons for the different standards in antitrust law and industry specific regulation law. The narrow scope of antitrust law to protect competition and prevent anticompetitive behavior does not subsume the broad policy to promote the public interest.

Antitrust cannot replace regulation unless it can be conclusively shown that the underlying conditions have changed.

- Thus, the purpose of antitrust applied to these sectors is to probe for areas where the underlying assumptions of market failure no longer apply and to ensure that the market power at the heart of the sector is not extended to

[10] I elaborate on these observations in Cooper, Mark, "Introduction" and "Making the Network Connection," in Mark Cooper (ed.), *Open Architecture as Communications Policy: Preserving Internet Freedom in the Broadband Era* (Stanford: Center for Internet and Society: 2004), "The Economics of Collaborative Production in the Spectrum Commons," *Conference Record: 2005 1st IEEE International Symposium on New Frontiers in Dynamic Spectrum Access Networks* (November 2005).

[11] Brett Frishmann, "An Economic Theory of Infrastructure and Commons Management," *Minnesota Law Review,* April 2005.

other sectors where markets can function. In this sense, antitrust fences in the sectors where market failure is likely.

- It is critically important, however, to recognize that where a transition from regulation to deregulation is undertaken, a strict standard that the transitional markets are workably competitive should be imposed before they are deregulated.

Let me stress that this antitrust analysis must deal with the underlying fundamentals of the markets in these industries. Abstract theories of why competition is better are irrelevant if the market forces in these industries are weak. Moreover, while there is a tendency to assume that antitrust analysis will favor deregulation, since markets are the preferred institutional structure, it should be clear that the analysis can lead in the opposite direction. Antitrust authorities should be open to the possibility that market fundamentals are so weak that antitrust alone cannot do the job. In short, antitrust authorities should be willing to recommend more regulation, if that is what the analysis suggests.

I frequently make this point with reference to a seminal article by Landes and Posner who underscored the importance of the elasticity of demand[12] by analyzing the Lerner Index.

As the members of this Commission well know, the Lerner Index is a measure of the mark-up of price over cost and a frequent starting point for a discussion of the empirical measurement of the price impact of market power.[13]

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[12] Landes, W. M. and R. A. Posner, "Market Power in Anti-trust Cases," *Harvard Law Review*, 19: 1981) p. 947. "Since market share is only one of three factors in equation (2) that determine market power, inferences of power from share alone can be misleading… The proper measure will attempt to capture the influence of market demand and supply elasticity on market power."

[13] As Scherer, F. M. and David Ross, *Industrial Market Structure and Economic Market Performance* (Boston: Houghton Mifflin, 1990), pp. 70…71, note, the *Lerner Index* is defined as:

L = (Price – Marginal Cost)/ Price.

Its merit is that it directly reflects the allocatively inefficient departure of price from marginal cost associated with monopoly. Under pure competition, [Ll]=0. The more a firm's pricing departs from the competitive norm, the higher is the associated Lerner Index value. A related performance-oriented approach focuses on some measure of the net profits realized by firms or industries.

Landes and Posner state the price cost margin as the firm's elasticity of demand. They then transform the index into an expression that uses market shares of firms and the market elasticity of demand and supply. Landes and Posner point out that when demand elasticities are low, market power becomes a substantial problem. In their words, the Lerner Index "comes apart."[14]

In the face of low elasticities of supply and demand, market power is magnified in two directions.

- Firms with relatively small market shares at low levels of concentration by traditional standards can exercise market power.[15]
- Firms with large markets shares have greater market power than would normally be observed.

In both cases, traditional antitrust analysis underestimates market power and, therefore, may expose consumers to greater risk of abuse.

An even more blatant mistake along these lines – unleashing market power to harm competition and consumers – has been made in transitional industries. Because policymakers

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[14] Landes and Posner, p. 942.

[T]he formula "comes apart" when the elasticity of demand is 1 or less. The intuitive reason is that a profit-maximizing firm would not sell in the inelastic region of its demand curve, because it could increase its revenues by raising price and reducing quantity. Suppose, for example, that the elasticity of demand were .5. This would mean that if the firm raised its price by one percent, the quantity demanded of its product would fall by only one-half of one percent. Thus its total revenues would be higher, but its total costs would be lower because it would be making fewer units of its product.

Raising price in these circumstances necessarily increases the firm's profits, and this is true as long as the firm is in the inelastic region of its demand curve, where the elasticity of demand is less than 1.

If the formula comes apart when the elasticity of demand facing the firm is l or less, it yields surprising results when the elasticity of demand is just a little greater than 1. For example, if the elasticity of demand is 1.01, equation (la) implies that the firm's price will be 101 times its marginal cost. There is a simple explanation: a firm will produce where its demand elasticity is close to one only if its marginal cost is close to zero, and hence a relatively low price will generate a large proportional deviation of price from marginal cost

[15] This is a problem in industries that are not regulated, such as the gasoline and natural gas wellhead sectors, see Cooper, Mark, *Record Prices, Record Oil Company Profits: The Failure of Antirust Enforcement to Protect American Energy Consumers* (Washington, D.C.: Consumer Federation of America and Consumers Union, September 2004).

have failed to adhere to the principle that workable competition must be in place before deregulation takes place, consumers and competitors have been thrown into a black hole where neither market forces nor regulation restrains abuse and antitrust scrutiny is preempted. Regulators declare market-based rates or open markets without assessing the nature and extent of competition. When incumbents abuse their market power, they invoke the presence of regulation as a bar to antitrust liability.

The resolution of this "Catch 22" is obvious. Where the regulation invoked relies on the presence of competition or claims about open markets or market forces, market participants should be subject to the full force of the antitrust laws. Perhaps the most ironic aspect of this anticompetitive limbo is the fact that it has developed in cases where Congress was promoting regulation and could have carved out a space to be free from antitrust scrutiny, but chose not to do so.

- Where Congress has not explicitly suspended the antitrust laws, the courts certainly should not.
- Where Congress has explicitly said the antitrust laws should apply, the courts should obey the will of Congress

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QUASI-ANTITRUST WITHIN THE REGULATED INDUSTRY

There is a second role for antitrust, or quasi-antitrust analysis in the regulated industry. Regulators should act like antitrust officials in overseeing mergers and other potentially anticompetitive behaviors within the sector.

For example, mergers may be proposed within a regulated sector based on claims of synergies and economic efficiencies. In a competitive market, the antitrust official will analyze the likelihood that these efficiencies will be passed through to the public given the level of competitiveness in the market and the impact on competition of the merger. In the

regulated sector, where competition is feeble at best, such a pass through is unlikely. If the merger is to promote the public interest, then the regulator may have to require the sharing of some of the claimed efficiency gains with consumers.

Similarly, when mergers involve vertical integration, or cross-technology acquisition, regulators must be keenly aware of the potential for the abuse of leverage. Vertical leverage has not been a major concern of antitrust official in recent years because of assumptions about incentives to internalize complementary externalities. Regulated industries open two sources of gain that may outweigh the incentive to internalize complementary externalities.

- Where market power in the core business is great, but neighboring markets are more competitive, incumbents with market power may find it profitable to leverage the linkages to exclude competition and suppress output.
- Where related markets may provide an avenue for entry by competitors, incumbents with market power may find it profitable to impede market development through vertical integration. In these cases, the exceptions may swallow the rule that vertical integration will promote efficiency.[16]

In these industries, regulators generally have the tools to address the problem because they regulate interconnection and carriage. Antitrust officials will generally not have these tools available, or will be disinclined to use them because of their behavioral thrust and need for continuing oversight. In short, what the regulator can do, that the antitrust official cannot, is better separate the wheat (economic efficiencies) from the chaff (abuse of leverage in complementary and vertical markets).

State regulatory agencies and antitrust authorities should also participate in the oversight of these industries in precisely the same way that federal antitrust authorities and

[16] Cooper, Mark, "Open Communications Platforms: The Physical Infrastructure as the Bedrock of Innovation and Democratic Discourse in the Internet Age," *Journal on Telecommunications & High Technology Laws,* 2:1, 2003; "Antitrust as Consumer Protection in the New Economy: Lessons from the Microsoft Case," *Hastings Law Journal,* 52:4, 2001; *Cable Mergers and Monopolies: Market Power in Digital Media and Communications Networks* (Washington, D.C.: Economic Policy Institute, 2002).

regulators do. These infrastructure industries are very much local industries. As networks, the first mile is a critical mile. That is where market power is likely to be greatest. It is also where many of the costs are recovered. For example, three quarters of the costs of wireline telephone service are still recovered in the local jurisdiction. Even in wireless, three-quarters of the usage is intrastate. In electricity and natural gas markets, local distribution still constitutes a substantial part of the delivered costs and distribution remains a natural monopoly. Cost conditions in first mile facilities vary by geographic area and population density. The local utility is the point of contact with the customer. Thus, there is no doubt that local authorities should be given a key role in overseeing both the antitrust policy and the regulations that affect these industries.

CONCLUSION

Thus, a division of labor between antitrust authorities and regulators a the federal and state levels emerges in which the each agency focuses on the area in which it has the expertise and tools to most effectively address policy concerns. Antitrust authorities take lead responsibility for competition policy. Regulators deal with oversight over areas of continuing market power. Where claims of or aspirations to create competition and markets are made, regulation should not be used to undermine, weaken or prevent antitrust oversight. Where regulation remains in force, antitrust should not undermine, weaken or prevent regulatory oversight from accomplishing its public interest goals that these industries serve. Multiple reviews reflect the importance and complexity of these sectors and the key role they play in our economy and society.