# Comments To The Antitrust Modernization Commission On

# Regulated Industries

Submitted by

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Summary: This comment focuses on the regulated industries undergoing transition to more market oriented processes. In general, this has proven to be a very good public policy and should be continued. However, it is important to appreciate the need to create an appropriate legal framework to constitute and facilitate the new, market oriented processes. The development of such frameworks is beyond the capacity of the antitrust laws. However, in the case of merger, while merger and consolidation is often essential to the reorganization of these markets, it also raises concerns about their long run competitiveness. Experience shows that the least desirable merger decisions have occurred when the regulatory agency has had exclusive jurisdiction. Hence, the antitrust enforcement agencies should always have concurrent authority in any regulated industry that is undergoing transition of a more market oriented system.

*Introduction*

I have been a teacher and scholar of antitrust and competition law for more than three decades. A substantial part of my scholarly life has been directed to studying the interaction between antitrust law and other regulatory regimes that often provide full or partial exemption from antitrust law. I have recently been engaged in focused studies of several statutory exemptions. In addition I am a co-editor of a forthcoming book that examines the impact of mergers on competition in seven "deregulated" industries (gas, electricity, banking, airlines, railroads, hospitals and telecommunications).[1] The authors of the case studies recently convened in Madison to discuss their chapters. These comments draw upon the insights that I obtained from those discussions, but these comments are my own and should not imply that my co-authors necessarily agree with my conclusions.

My comments primarily focus on industries in the process of transition to a more market oriented system for major economic decisions. As a result, they are primarily responsive to questions 1, 2, and 6 in the Request for Public Comment.

*"Deregulation" Has Been an Overall Success*

Without exception, the movement toward greater market orientation and greater flexibility for businesses to decide what and how to produce goods or services has been positive. The gains in efficiency in some industries, e.g., railroads, have been very substantial; the quality and range of services have improved in most industries. Hence, the overall conclusion is that "deregulation" has been and is a successful public policy. At the same time, aspects of these industries have significant monopoly characteristics or have the potential for strategic conduct that can exclude competition and exploit consumers. Hence, the label "deregulation" is in fact inappropriate. Instead, it is more useful to think of this as revised regulation that seeks to use market forces to the maximum extent feasible to achieve the public interest goals of efficient, dynamic, and reasonable performance by these industries.

*Law and Regulation Are Essential to Facilitate Desirable Market Processes*

The first point that needs to be clearly understood is that market processes require a legal framework. Some of our most competitive markets, i.e., public capital markets and commodities markets, have very detailed rules whose function is to facilitate the efficient, open, and fair operation those markets. One major failing in a number of "deregulatory" efforts has been the unwillingness to recognize that a significant legal framework is required to get the fullest benefit from the transition to a market oriented process.

Industrial organization economics has often used a paradigm of "conditions, structure,

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[1] Peter Carstensen, Beth Farmers, eds., Competition Policy and Merge Analysis in Deregulated and Newly Competitive Industries (forthcoming 2006).

conduct, and performance" to describe economic activity. Without having to accept any of the relative weights that different scholars put on the role of structure or conduct in shaping ultimate performance, it is helpful to appreciate that the basic conditions under which industries operate include not only the conventional considerations of supply, demand, technology and similar exogenous variables but also the legal and social conditions that define the rights of ownership, employment, and marketing. These later conditions are endogenous in that they are the product of explicit choices about how to define and allocate rights and responsibilities. An economy without a viable law of contract but with strong rules governing employment, e.g., serfdom, would have a very different economic organization than one with relative freedom for workers and a workable set of contract rules. Indeed, one of the great challenges for the formerly socialist economies of eastern Europe and Asia is to develop the legal institutions and the related public understanding of those institutions that are the prerequisites of a market economy.

*Transitions to Markets Require Changes in Firm Structure and Conduct*

Second, the transition from conventional command and control regulation to a market oriented, but still legal constituted system, requires restructuring of industries that developed under a very different set of economic parameters. The kind of reorganization will vary from industry to industry, but it is likely to include substantial merger and consolidation of firms. At the same time, it may be essential to have disintegration of firms that historically controlled several levels of an industry. Gas and electricity are contrasting examples of this situation. Vertical disintegration was very feasible in the gas pipeline business because most of that integration was by contract that the FERC could terminate. In electricity, creation of an integrated, accessible transmission system has proven very difficult because major power companies "owned" both generation and transmission facilities. FERC has not found the authority to order the disintegration these relationships so that a truly integrated transmission system could develop. Without legislative action to empower FERC to demand significant reorganization of ownership of transmission assets so that the structure of those assets was more akin to that of railroads or gas pipelines (i.e., strictly transportation service providers), the problem of creating a workable wholesale market and ensuring adequate transmission capacity remains very difficult.

In telecommunications, in both the early 1980s at the time of the AT&T break up and again in 1996, the ILECs created by the Bell System were allowed to remain as regional monopolies. An alternative would have redistributed ownership of local exchanges so that the new ILECs were compelled to work with each other. This would have been likely to cause them to open their facilities more willingly as an essential step in developing their own business. Instead, the industry has concentrated around an increasingly small number of integrated providers with regional monopolies of land line facilities. The failure to create a new pattern of ownership for the key assets in the telecommunications industry meant that existing market power remained and that market participants lacked any strong incentive to find workable solutions to the challenges of sharing bottleneck assets.

A third, conduct oriented example of the failure to constitute markets comes from the

airline industry where the capacity to vary prices on the part of incumbent airlines is very great. This is true both for inherent reasons (travelers want to get from a specific point to a specific destination) and endogenous legal factors (tickets can not be resold and so arbitrage is impossible). Two problems result: first, travelers to a hub city or to a location served by only one airline pay very high prices; second, without engaging in predatory prices as defined in antitrust law, incumbent airlines can impose significant costs on and thereby deter new entry in many markets by discounting tickets and increasing the capacity dedicated to the competitive market element. It is probably the case that no one anticipated the kinds of issues that actually arose in the airline business until after price and entry regulation was eliminated. But in freeing airlines to set their own fares, it would have possible to impose a version of the "short haul-long haul" rule: The price for a short haul can not exceed the price of a longer haul that includes the short haul. This was one of the price discrimination controls used in railroad rate regulation and its has the utility of constraining the capacity to discriminate among travelers in some situations. A number of possible rules have been discussed to address the entry deterring capacity and price problem. None is entirely satisfactory, but the potential for rules to control such conduct emphasizes that the role of regulation in constituting markets and facilitating or discouraging entry and competition on the merits.

The essential and consistent observation is that workable, desirable economic competition in these industries requires self-conscious development of legal rules to facilitate such conduct in the market. Rules that create structures and basic legal conditions that limit the incentive to engage in strategic conduct (exclusionary or exploitative) are a vital but deeply underappreciated part of the process. Hence, it is not appropriate to rely on antitrust as the primary tool to shape the structure or conduct of the emerging market orientation. Antitrust assumes a workably competitive context from which individual firms have deviated. When an industry is making a transition, the problem is to define the market context. This is very difficult because in greater or less degree, the actual needs of the new market will only emerge as the market develops. For this reason, regulatory agencies ought to have relatively broad mandates to adopt and revise rules that will govern the emerging markets. But that regulation needs to be framed in light of clearly defined Congressional goals of achieving workably market oriented institutions wherever possible.

*Merger Policy Requires An Independent Role of the Antitrust Agencies*

Within this process of transforming markets, there should be very careful evaluation of mergers from both a standard antitrust perspective and a forward looking regulatory one. On the one hand mergers can be particularly desirable in these industries exactly because of the need to achieve transitions to a new market framework. But, on the other hand, the implications of mergers for that new framework will be particularly hard to define. This is true because freeing these industries often releases a great deal of technological innovation as well as shifts in consumer demand. Hence, it is very hard to predict the future effect of mergers.

Another complicating factor is that the regulatory agencies often use conditional merger approval as a means to achieve deregulatory goals where the agency lacks direct authority. Both

the FCC and FERC have made use of conditions attached to mergers to promote market change. In the absence of better statutory authority, such conditional approvals are probably an important tool for the agencies. However, this strategy has serious limits because it can involve significant competitive costs incurred to induce changes in other dimensions of the firm's behavior. In the *Enova* case, for example, the Antitrust Division insisted on divestiture where FERC had only imposed conduct oriented relief.

My own view is that merger policy over the last 30 years has become far too tolerant of mergers that eliminate diversity in the market place. This should be a particular concern in industries going through transitions because it is hard to predict what the future will look like. A policy of retaining more rather than fewer actual or potential competitors would seem desirable in the face of such uncertainty. I realize that contemporary views on merger policy are much more tolerant of high concentration. Regardless of the level of concentration that is deemed acceptable, the key point is that for markets to work competitively there must be at least some minimum threshold of competition.

Hence, the instrumental agency use of merger review means that it is particularly important for there to be a second review from conventional antitrust enforcers. Where the agencies are doing a reasonable job, as in banking, electricity, and telecommunications, the predictable result is that the second, antitrust, review will rarely interfere with the agency decision. It is however striking that the Antitrust Division has contested very few FERC approvals of electricity acquisitions, but the FTC has been relatively active in policing gas pipeline mergers.

Among the seven industries that we examined, the most questionable merger results were in railroads and airlines when the agency had exclusive authority to review the merger. In airlines, there is a clear contrast between the poor decisions of the Secretary of Transportation to allow the Northwest-Republic and TWA-Ozark mergers (over the Antitrust Division's strong objections), the subsequent enforcement decisions of the Division once the right to review mergers devolved on it.

In railroads, the Surface Transportation Board retains exclusive authority to pass on mergers and acquisitions of railroad assets. Its decisions, again despite Antitrust Division opposition, to concentration rail service into two major truck lines in both the east and the west are highly questionable. In addition, the major rail lines sell abandoned tracks, they often impose requirements on the buyer that restrict the buyer's ability to deliver traffic to any other railroad that the short line might be able to connect with. Up to now the STB has accepted these restraints eventhough they undermine the goal of creating a workably competitive system of rail services. If the STB no longer had the power to grant antitrust immunity to mergers and sales of short lines, conventional antitrust standards would both deter any further mergers absent some very compelling justification and cause the anticompetitive restraints on short lines to be abandoned. These considerations illustrate why agency review of mergers and sale of assets ought not to be exclusive.

*Conclusion*

In sum, the process of transition from command and control regulation to market oriented regulation is complex and difficult. Overall, the increased reliance on markets has proven to be a very successful innovation in the management of our economy. It will work better as all involved understand that the process is one of changing regulation and not just eliminating it. With that core insight, the goals of the new regulation are to create the legal conditions under which desirable market conduct is likely to occur. Such regulation should have as its primary goal minimizing the incentive to engage in strategic conduct that exploits consumers or excludes competitors. As industries are being transformed, merger and consolidation is to be expected. But there must be effective oversight to ensure that the resulting structure remains consistent with the underlying goal of a workable market.