Letters

We welcome letters from readers, particularly commentaries that reflect upon or take issue with material we have published. The writer's name, affiliation, address, and telephone number should be included. Because of space limitations, letters are subject to abridgment.

A New Era in Merger Enforcement?

TO THE EDITOR:

Joe Sims and William Blumenthal ("The New Era in Antitrust," *Regulation*, July/August 1982) have made a courageous effort to analyze the Justice Department and Federal Trade Commission's recent statements on merger policy—statements that are no doubt somewhat mysterious to outside (and even inside) observers. As one who voted to issue the FTC's statement, I offer my own views (not necessarily those of the other commissioners) about what those statements mean.

The authors speculate as to why the commission did not address conglomerate and vertical mergers in its statement. We did not do so largely because there is much less consensus within the commission on those matters and because there is less certainty about what new guidelines would be. The conventional theories applicable to conglomerate and vertical mergers—vertical foreclosure, potential competition, and entrenchment—may not be adopted by the current commission in its enforcement policies, but they remain nascent.

Sims and Blumenthal interpret the commission's statement to mean that we will not rely on presumptions based on market shares as much as the Justice Department will. Our statement should decidedly *not* be interpreted in that way. A majority of the commissioners never saw a draft or final version of the Justice guidelines until they were released; we intended only to provide a complement to the new market share thresholds we assumed Justice would adopt, not to give more weight to non-market share factors. Our mistake was in not saying so.

As for the commission's treatment of efficiencies, the authors should look again at the narrowness of our language about when claims of efficiencies will be considered. I view our position as the same as Justice's: only in the most exceptional cases will claims of efficiencies be considered at the stage of prosecutorial discretion. I do not find it disturbing that a factor may be considered in exercising prosecutorial discretion even though it is not a recognized defense when a case is eventually decided. Prosecutors frequently apply this principle, for example, in choosing which of many violators to pursue.

Three aspects of the Justice guidelines are disturbing. First, they assume the availability of precise information that will almost always be lacking. For example, they rely on calculations of the amount of entry expected over various time periods based on hypothetical price increases. Second, depending on how the guidelines are implemented, they threaten to undercut merger enforcement by defining markets very broadly and by insisting on proof of entry barriers in every case. For example, the guidelines allow *possible* foreign imports to be included in measuring the size of the market. While there is some theoretical validity to this idea, the seeds for speculation are fertile, and reasonable market share thresholds become insignificant when even the largest firms' shares of very large markets are small. As for barriers to entry, the ultimate Catch-22 foisted upon us by noninterventionist economists is to require proof of entry barriers and then to refuse to accept any condition of entry as a true "barrier."

A final defect in the guidelines (and one to which the FTC did not succumb in its statement) is that they embrace efficiency of resource allocation as the exclusive concern in merger cases. The empirical data on concentration and supracompetitive profits are imprecise, but quite consistent with the theoretical notion that domination of an industry by a few firms reduces its competitive vigor. Yet we do not know precisely what the size threshold is above which combinations are likely to reduce competition, and it is likely that we will always have only a rough approximation. There are other values that our society cares about, however, that underlie the antitrust laws, including preserving consumer choice, maintaining a diversity of competitors, and avoiding concentration of economic power in the hands of the few.

The proper way to balance these considerations is to designate minimum market share thresholds that arouse concern based on profit and concentration data. (The actual thresholds used in the guidelines are reasonable in this respect. They also tend to allow for genuine scale efficiencies.) When market shares clearly fall within the range of concern, the government should not have to shoulder an impossible burden of proof, as it would if it had to show entry barriers in every case, or if it had to investigate any theoretical future market development that might negate some harmful effect of the merger. When market shares are closer to the minimum end of the range, on the other hand, antitrust enforcers can legitimately rely more on qualitative factors. The guidelines seem to suggest, however, that we can in *all* cases precisely identify and screen out for our challenge those mergers that will distort efficient resource allocation, leaving the "harmless" ones untouched, and that we can allow for endless speculation about the market's self-correcting potential. It is this naive reliance on our ability to apply elegant economic theories—the "halo of science," as Sims and Blumenthal put it—that may be the most troublesome development of all.

Michael Pertschuk,
Federal Trade Commission

Economic Evidence and FTC Rulemakings

TO THE EDITOR:

Timothy Muris ("Rules without Reason—The Case of the FTC," *Regulation*, September/October 1982) points out two systematic deficiencies in the Federal Trade Commission's much-maligned rulemaking activities. The first is that the agency's rulemaking records, in spite of

their enormous volume, contain little reliable evidence; the second is that the proposed rules themselves lack persuasive theoretical foundations.

The first criticism has stimulated strong reactions from some defenders of the FTC. They can point out that unreliable evidence, nonexistent agency expertness, unrepresentative anecdotes, experts' opinions on matters beyond their expertise, and faulty surveys are often accepted in other policy areas as a basis for rulemaking and even legislation. But considering how much time and money the commission has invested in these proceedings over the past seven years, it is hard to fault Muris for having higher expectations.

The commission's failure to offer convincing legal and substantive theories to support its proposed rules is a harsher criticism, but this deficiency is not solely the fault of the commission. Congress has given the FTC very little guidance in the basic statutes that the agency administers, and the courts have in general expanded the commission's very broad powers even further. In cases like this, where neither Congress nor the courts provide any more meaningful theory of the public welfare than that of eliminating "unfairness" and "deception," it is hard for an agency to avoid inconstancy in its rulemaking theories. To his credit, and in the face of sharp criticism by FTC defenders, Muris has designed legislative proposals to sharpen the commission's statutory mandate.

Although Muris confines his criticisms of FTC rulemaking theories to matters of "law" and "substance," it seems clear that as an economist as well as a lawyer, he also has difficulty with the lack of consistent economic justification for many FTC rules. The problem may be simply that economic reasoning was not as fashionable when the proposals were made around 1975 as it had become by the time the proposals approached the final stages of decision.

A better explanation for the deficiencies can probably be found in the motives of the key actors. FTC staffers who support a rule that is long on political, social, or ethical justifications and short on economic ones are likely to fill the record not with economically relevant and reliable evidence, but with "horror stories" and legalisms instead. Industry antagonists have also had little incentive to provide such evidence; they have contented themselves with the generally successful strategy of simply attacking the staff's submissions and waiting for the deficiencies in the rulemaking records to be discovered by Congress, the commission, or the courts.

An inability to develop sound evidence and theories, however, is only one of the FTC's problems. The recent and nearly successful efforts in Congress to forbid it from scrutinizing cartels in the professions remind us that economic reason and facts may be necessary, but are never sufficient, for the commission to succeed in its regulatory activities.

Calvin J. Collier,
Washington, D.C.

TIMOTHY MURIS responds:

My article sought only to document the lack of evidence that characterizes the FTC's rulemaking records. Although the commission has spent millions of dollars in the past decade developing nearly twenty rules, the records, with rare exceptions, contain no reliable evidence on costs or benefits and no reliable evidence on other crucial issues, such as how consumers interpret advertisements or whether they understand disclosures that the commission proposes to require.

Former chairman Collier suggests that these deficiencies may be explained by the motives of the key actors. Although judging motives is tricky at best, my approach to rulemaking differs fundamentally from that of many of my opponents on this issue.

Take, for example, the commission's recent decision not to extend its care-labeling rule to carpets, furniture, and other household products. A nationally projectable survey showed that generally more than 95 percent of those who sought care information when they bought the products could already find it and that a comparable percentage of the owners of the products were satisfied with their last attempt at cleaning. Despite this evidence, two commissioners voted to extend the rule, apparently relying on their role as "experts."

There is a belief, once prevalent among administrative law scholars and still fashionable in Washington today, that nothing is wrong with administrative agencies that better regulators could not cure. All we need to do is find these Platonic philosopher-kings, the argument runs, and then let their expertise guide us, subject to little direction other than that of acting in the "public interest."

I disagree. There is nothing in the experience or training of the lawyers who dominate the commission that enables us to make informed decisions about care labeling, food advertising, funeral practices, or any of the other numerous matters we regulate, unless we first rely on valid extrinsic evidence.

I see no solution to the problem of agency reform short of writing statutes that constrain the discretion of unelected bureaucrats. Most agencies should have some discretion, but discretion limited by clear guidance, not the nearly unlimited discretion that they have now.

Deregulating the Electric Utility Industry

TO THE EDITOR:

Irwin Stelzer ("Electric Utilities—Next Stop for Deregulation?" *Regulation*, July/August 1982) discusses difficulties with one particular scenario for deregulation, the MIT model. There are other alternatives, however, that may be more feasible politically and practically. One of them, which I would like to discuss here, is to increase competition without fundamentally restructuring the industry.

There is competition in the industry today at the "bulk power" level. It manifests itself in two slightly different ways. A local utility that generates no power itself shops for an inexpensive and reliable source of bulk power, usually to meet its full needs. A utility that generates all or some of its own power, however, will buy not only power as such but also what are called coordination services, including such things as emergency and short-term service, back-up sources, and spot-market power as it becomes available at attractive rates. These transactions are multifarious and complicated, and a generating utility will usually take part in the market as both a purchaser and a supplier of coordination services. The search for economic sources of wholesale power and coordination services gives rise to healthy competitive rivalry and, by implication, efficient resource allocation.

The opportunities for competition at this level have been increasing in recent years, for reasons such as technical advances in generation and the growth of interconnected transmission grids. As system planners and consumers pick and

(Continues on page 49)

(Continued from page 3)
choose from more and more alternatives in a region, and the price of electricity comes closer to reflecting its true marginal cost, the most efficient producers will expand and the inefficient ones will contract—all through market-based decisions rather than regulation.

There is one potential difficulty, however. The regulated prices that utilities must pay for bulk power are not based on marginal costs. Thus competition alone will not necessarily suffice to bring about efficiency; the current pricing regulations have to be changed first. One way the Federal Energy Regulatory Commission could experiment with this is by designating certain geographical areas as candidates for competition. In these areas, sales of bulk power and transmission services could be completely, explicitly deregulated. In exchange for this deregulation, utilities participating in the scheme would have to "wheel" power—that is, allow their system to be used to transfer power from one neighboring utility to another at a cost-based fee. Deregulation could also be extended to smaller "incremental" generating units, whether owned by utilities or by independent entrepreneurs, thus bringing about a market-based test of whether incremental generating is socially desirable. If a small generator were unable to find willing buyers for its output, it would fail, presumably because its costs were too high.

To extend competition and efficiency in this way, of course, pricing regulation would have to abandon its reliance on historic (instead of marginal) costs. That change, however, would be fairly easy to accomplish compared with a massive restructuring of the industry.

T. Crawford Honeycutt,
Department of Energy

TO THE EDITOR:

Stelzer's excellent synthesis of the so-called prototype deregulation model may understate the formidable problems, both theoretical and practical, of vertically disintegrating the industry and creating a competitive bulk power supply system. As he notes, however, there are a number of less "radical" alternatives to the prototype model. These may provide some of the same benefits as total deregulation of generation without the substantial risks and uncertainties of a massive industry restructuring. Such options include:

(1) *Deregulating pure generating firms.* Firms that do nothing but generate electric power could be exempted entirely from both federal and state price and entry regulation. The Public Utility Regulatory Policies Act's restrictions on allowable technologies and plant size would be dropped, but so would the guaranteed market at "avoided-cost" prices that PURPA now provides to qualified facilities. New entrants to the market would have to compete on the merits of their projects.

Some will argue that workable competition in bulk power supply is unlikely unless firms with control over transmission lines have common carrier obligations. Nevertheless, this approach might provide a limited test of whether there really is a reservoir of untapped potential for efficient and innovative generation that is now being inhibited by regulatory barriers.

(2) *Deregulating bulk power sales between systems.* Certain types of wholesale bulk power sales between utility systems could be exempted from both federal and state regulation. Although specific transactions, such as unit power sales arranged *before* a new plant is built, seem to have more potential for competitive pricing outcomes than others, virtually all types of transactions would initially be considered for exemption. The only exception would be contracts for a distributor's full power requirements. In the latter case, the buyer's lack of assured access to alternative sources of power supply (through guaranteed "wheeling") would make workable competition highly unlikely.

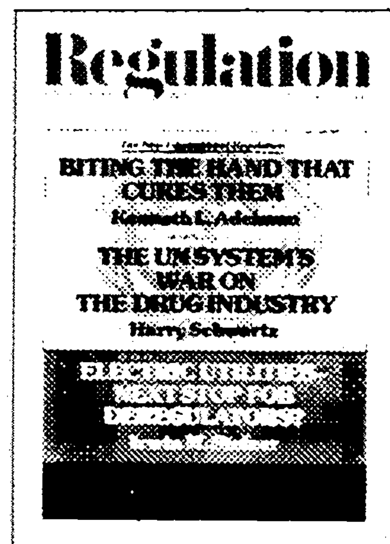
(3) *Bringing rate regulation closer to market outcomes.* Regulators could decide to step in only in clear cases of market dominance by one supplier or purchaser. In those cases, they would fix allowable returns consistent with market levels and set customer rates at a level that ensured the utility an *opportunity* to earn that rate of return. Where a utility failed to earn a market return, its revenues would be presumed to be inadequate and its rates would be allowed to increase accordingly. Utilities would also be given more pricing flexibility to meet competition from other energy forms. Finally, the utility's "obligation to serve" would be redefined to reflect customer willingness to pay for a particular level of service.

While these options lack the theoretical elegance of total bulk power deregulation, they may offer more practical ways to relax regulatory burdens and introduce more competition into the industry in the near term. Stelzer's cogent arguments on the risks and uncertainties of the prototype deregulation model suggest that such alternative strategies should receive our careful consideration.

Jerry L. Pfeffer,
NPS Energy Management, Inc.

TO THE EDITOR:

As Stelzer says, we should be concerned about the current state of electric utility regulation, not just because of the industry's poor financial condition, but because of the continuing lack of incentives for efficiency and innovation in both the use of existing generating sources and the development of new capacity. Competition among producers could go a long way toward curing these ills, but it would mean separating the generating, transmission, and distribution components of the industry from each other. The trick is, first, to retain or even improve the existing coordination of the electric system and, second, to provide the assurances that would allow investors to build new generating plants.



Some proposals, including mine, would assign the task of coordination to the owner of the transmission system, whom I call the "energy broker." Such a transmission company would not have to be a monopoly buyer. My proposal would have distributors make their own

deals directly with generating companies in their region for power and energy. Thus, there would be numerous participants in both the demand and the supply sides of the market. The power a distributor would actually take out of the broker's system might have been fed into that system by some generating company other than the one the distributor had contracted with. The regional broker would obtain power as it is needed from the lowest-cost generators in the system, but each distribution company would pay for the energy it received as though that energy had been provided from the capacity the company had purchased. Normally the broker's energy costs would be less than his receipts from the distribution companies. His profit would be shared with the distribution companies in a way that would encourage distributors to purchase energy-efficient capacity of a type that would best match future load patterns in the region.

If new capacity is to be built, extensive use of long-term take-or-pay contracts would be necessary. But this need not eliminate incentives to efficiency in either construction or operation. Generating companies would compete for contracts on the basis not only of capital costs but also of performance standards listed in the contract. Specified bonuses and penalties and capacity sales in secondary markets would provide continuing incentives for operating efficiency.

In my proposal, the risks to capacity development in a vertically separated industry would be reduced in several other ways. Some regulatory risks would be ended, and planning and licensing risks would at least be known before any capacity was sold. Forecasting risks would be borne by the distribution companies. Thus, the principal risks facing a generating company would be the uncertainty of its own future construction and operating costs, which are the risks it is best able to control. With risk held to reasonable levels in this way, there would be no reason to believe a free market could not accommodate the risk premiums that investors would require.

William W. Berry,
Virginia Electric and
Power Company

IRWIN STELZER responds:

I am delighted that my article prompted such thoughtful responses. Let me comment briefly on the main points made by Honeycutt, Pfeffer, and Berry.

Honeycutt's basic view is that opportunities for competition at the bulk power level have been increasing, but that regulations that prevent prices from reflecting marginal costs continue to impede efficiency. His suggested remedy is to decontrol prices in a given area when regulators think it has become sufficiently competitive (because the local utilities have agreed to wheel power). Pfeffer's second alternative is similar. As I noted in my article, I concur with this view; if anything, our proposals may not go far enough. As my colleagues Joe Pace and John Landon have written in the *Energy Law Journal*, "the bulk power market could be made more competitive by phasing out embedded cost wholesale rates over a period of years and allowing all firms to shop freely to meet their additional and replacement capacity requirements. This might be accomplished," they add, "by limiting the rights of wholesale customers to a share of the output of the embedded cost facilities of their present supplier and requiring them to contract for additional needs from any interconnected utility at prices reflecting the marginal costs of these systems."

Pfeffer's first alternative, deregulating pure generating firms, again is similar to my own suggestion that free entry be allowed into the generating industry. His third alternative, that regulators step in only in clear cases of market dominance by one supplier or purchaser, is fine theoretically, but may not give us very much new deregulation. Realistically, it is hard to imagine any utility that would not dominate all its retail markets.

Berry describes his own comprehensive deregulation proposal, which would involve horizontal and vertical disintegration of the industry. While he does have a specific plan for capturing the economies of coordination, he leaves the other questions raised in my article unanswered. In particular, his reliance on the "extensive use of long-term take-or-pay contracts" is troubling. The use of such contracts would in effect reintegrate the industry, and their cost-plus nature would invite regulatory oversight and intervention. That a prominent utility executive should take the lead in considering radical alternatives to the status quo is so encouraging, however, that I hesitate to disagree further lest I discourage the spread of such open-mindedness. ■

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