Can Regulation and Competition Coexist? Solutions to the Stranded Cost Problem and Other Conundras

The introduction of competition into the electric power industry must be reconciled with the pre-existing and continuing regulatory regime if it is to be in the public interest. In particular, the equitable and efficient way of handling stranded costs is to shift them on to all uses of the wires, utility and non-utility alike.

Alfred E. Kahn

Since regulation is supposed to be a substitute for competition, the increasing encroachment of competition into the comprehensively regulated electric utility industry naturally raises the question, "can regulation and competition coexist?" My first answer is "They damn well better!" Competition is here to stay. It is not going to go away; nor in my opinion, should it. Regulators are also here to stay and they’re not going to go away; nor should they. But it is going to be a miserable coexistence or cohabitation unless both partners start making some adjustments. Ultimately, they had better start thinking about separate bedrooms, because in a number of very important ways they are simply incompatible.

The bad news is that if we don’t make the necessary adaptations of both regulation and competition, some electric utilities may end up like the airlines, which lost more money in three years than the industry had made in its entire history since Orville and Wil...
bur Wright first flew at Kitty Hawk. The good news is that most utilities have a lot more going for them than the deregulated airlines. There is a lot of natural monopoly in the electric industry. The exclusive direct contact with almost all their customers that the utilities enjoy gives them advantages and opportunities that are not going to disappear overnight. The persistence of natural monopoly also explains why regulators are not going to go away either. But the regulators with whom I have spoken in recent months and whose pronouncements I have read seem to me very much aware of the pitfalls on the path to more thoroughgoing competition, and are determined not to have the electric utilities end up like the airlines—at least not on their watch! I believe there is widespread recognition of the ways in which things can go wrong and of the urgent need to work together in order to get safely from here to there.

I begin by setting forth four propositions that I regard as almost self-evident and that would I think have until fairly recently commanded almost universal support outside of the industry and its regulatory community:

1. Competition is spreading in electric generation and is almost certainly going to become increasingly pervasive;
2. That is probably a good thing from the viewpoint of the consumer; but,
3. Regulation and competition are fundamentally incompatible; the term ‘regulated competition’

is an oxymoron (like ‘Inflation Czar’ or ‘postal service’ or ‘Democratic administration’). So as we rely more and more on the competitive market to ensure efficient performance, there’s not only less need for regulation; regulation can do positive harm, by distorting the competitive process;

4. Finally, however, because there are parts of the industry that remain naturally monopolistic, we are going to need regulation as far in the future as we can see, to protect customers who don’t have competitive alternatives and

The term ‘regulated competition’ is an oxymoron, like ‘postal service’ or ‘Democratic administration.’

The question is not whether the competitive market achieves optimum levels of conservation without assistance. It probably doesn’t. Or whether it protects the environment. It certainly doesn’t. The question is whether we are going to correct those deficiencies by preserving public utility monopoly and micromanaging it, as at least some conservationists and environmentalists want to do: use the power of the monopoly, protected from competition, to tax ratepayers and use the proceeds to do these virtuous things.

By far the better course if we see competition coming, I submit, is to embrace it as the best way of serving the consumer interest and then take care of its possible deficiencies in achieving efficient conservation and preserving environmental values in ways such as taxation or transferable emissions rights that are competitively neutral and make use of the efficiency of the market, rather than override it by regulatory micromanagement. It may of course be politically easier to accomplish those worthy social purposes by regulators making the utility companies undertake the good works while passing the costs onto ratepayers. It is also, however, profoundly anti-democratic and potentially inefficient—that is to say, injurious to consumers. But we can do it the efficient way: Witness the Clean Air Act, which, whatever its deficiencies, confines the government’s intervention to setting the social goals and then leaves it to the competitive mar-
Market to achieve them in the most efficient way.

Economic welfare is not a goal to be lightly dismissed, as it is all too often by well-educated, well-to-do intervenors in regulatory proceedings. According to the latest Economic Report of the President, the lowest 20 percent of our families experienced a very substantial decline in real income between 1973 and 1992 and the middle 20 percent just barely held even, mainly by two members of the family working for pay rather than one.

I believe the solution in the long run is to—

- Confine industry-specific regulation to the two functions I have already identified: to ensure fair treatment for consumers who lack competitive alternatives, and nondiscriminatory access of competitors to bottleneck facilities;
- Reform regulation of the monopoly services in ways that are more compatible than cost-plus, rate-base/rate-of-return with efficient competition;
- Genuinely deregulate the competitive services and the companies insofar as they participate in those markets, free of regulatory handicaps on their freedom to compete; and,
- In some ways the most urgent, use the period of transition—which probably has to be longer than California regulators originally contemplated—to prepare the ground or, to get back to my analogy, to prepare those separate bedrooms, complete with locks on the two doors.

With that introduction and recognizing, with John Maynard Keynes, that in the long run we are all dead, I will devote most of my attention to the problems of the transition.

1. The Irresistible Spread of Competition in Generation

In 1986, non-utility generators accounted for 15 percent of the additions to generating capacity. In the next five years their share averaged 49.8 percent, which is just about where people predict it's going to be in the next several years. So competition in generation is already here and spreading.

There are several reasons why I believe continuation of that trend is inevitable.

The first is that the incipient transformation of the electric industry is part of something much broader that's going on all over the world—the breaking up of centralized planning, cartelization and protectionism and the triumph of the market. The degree and extent of the change varies, of course, from one country to another. At one extreme are the macrocosmic transformations in East-

em Europe. Next are the privatizations all through Latin America, in England, Spain and Portugal, in New Zealand and Australia, with India in between. Finally, there have been the partial or thoroughgoing deregulations of individual industries in the United States—truckering, the railroads, airlines, telecommunications, oil, gas, financial markets. It shouldn't be surprising that the movement has extended to the electric and gas utilities.

Although these radical changes have been worldwide, the propelling forces have differed significantly from industry to industry. In telecommunications, it has obviously been the explosion of technology: The entire story can be told, essentially, in terms of microwave, the computer chip, satellite transmission, digitalization, fiber-optics and increased efficiency in the use of the radio spectrum.

In electric power, in contrast, the major motivating factor has been technological and institutional failure. I can't believe that we would be witnessing the changes we are witnessing today if the industry had been able to continue the performance of the '50s and '60s, when the average price of electricity in the United States dropped over 40 percent in real terms. I hardly need recount the intervening catastrophes of the '70s and '80s: the effects of double-digit inflation, high interest rates and long construction times, the exhaustion and reversal of economies of scale, the fuel crises, the nuclear fiasco and the sudden deceleration in the growth of...
demand. All of these ended up with a large part of the industry coming into the mid-’80s with enormous amounts of excess capacity, very high-cost plant entering rate base and then, at the same time, confronting a collapse of oil and gas prices.

All these developments have translated into marginal costs far, far below average costs or average revenue requirements in large parts of the country. In my part, with average rates in the eight to twelve cent per kilowatt hour range, we are talking about short-run marginal costs of two to three cents and the ability to build new plants and break even at rates of five cents a kilowatt hour, possibly even lower.

II. Competitive Supply and Stranded Investment

If there is one principle in economics that corresponds to the physical law that nature abhors a vacuum, it is that society abhors a great gap between marginal costs and price.¹

These huge gaps between true economic costs and regulated rates have given big buyers an irresistible temptation to shop around and pushed generating companies to seek business at cut rates out of territory. So we have a large, increasing number of transactions between willing sellers and willing buyers crossing previously inviolable geographical market boundaries. As a consequence, incumbent utility companies—their previously exclusive franchises subject to invasion—worry desperately about the prospective stranding of hundreds of billions of dollars of investments and their ability to recover the associated sunk costs.

These fears are compounded by the huge disallowances by regulators during the 1980s of costs sunk in expensive base load plants—which have also had a permanent effect on the willingness of utility companies to undertake long-lead-time investments. We used to worry about the Averch-Johnson distortion under rate-of-return regulation—the incentive to build costly plants in order to have a bigger rate base, on which companies would be permitted a return. Because of the disallowances in the ’80s, the industry experienced (and is probably still subject today to), in effect, a reverse Averch-Johnson incentive—a fear of expanding rate base and particularly of risky long-lead-time investments—which I think played an important role in making many electric companies complaisant about other people undertaking responsibility for investing in new generation.

Whatever the importance of this reluctance on the part of the utility companies, they have in any event been compelled by the Public Utility Regulatory Policies Act of 1978 (PURPA) and their state regulators—both in administering the Act enthusiastically and increasingly requiring competitive procurement—to purchase increasing proportions of their power needs from independent suppliers.

These rapidly accumulating purchase obligations, at prices dictated by state regulators and legislators that often either were from the outset or have turned out to be far in excess of the utilities’ own present avoided costs, have evidently made a multi-billion dollar contribution to increasing the yawning gap between the utility companies’ rates and marginal costs. And that gap has on the one side motivated buyers to seek out and on the other side motivated utility companies to offer bargain supplies out-of-territory—transactions that threaten in turn to leave stranded those same, inflated investment costs that have themselves threatened to produce the stranding.

If, however, the explanation of the radical institutional changes in the electric industry is rooted largely not in technology but in adventitious, transitory circumstances of the ’70s and ’80s—if it is in some way the consequence of abrupt changes in the relationship between marginal costs and average total costs—is it possible that the trend may reverse itself? I would not be the first or the last

Just as nature abhors a vacuum, society abhors a great gap between marginal costs and price.
economist to predict yesterday much more accurately than tomorrow. I think that is unlikely, however, for several reasons. First is the virtual universality of these historical trends; that’s why I began by pointing them out. Second, it is my impression that the trend of generating technology does not seem to be propitious to a return of monopoly. Instead, it appears that the major developments on the horizon—the combined-cycle gas turbine, small scale fluidized bed, fuel cells and co-generation—are largely centrifugal rather than centripetal, pushing in the direction away from natural monopoly and toward more competition.

Third, for all the differences among industries, regulation and deregulation have one characteristic in common: Once begun they have an almost irresistible tendency to become more and more pervasive, to the point of universality. This is a phenomenon that I have documented at length in other contexts.

III. Regulatory Distortions

One of the main reasons the process tends to be cumulative and self-reinforcing is that once you begin to loosen the bonds of regulation and admit competition selectively, it introduces strains and distortions that can typically be resolved only by further deregulation. In the case of airlines, extension of freedom of entry into individual markets soon led to extending it to all markets; conferring that freedom on a discretionary basis—competitors had to be free to enter but not compelled to do so—inevitably required relieving incumbents of the obligation to remain and serve: Freedom of entry necessarily implies freedom of exit. Again, removal of restraints on entry would quickly have produced a gross inflation of inefficient non-price competition had it not been accompanied by removal of restrictions on price competition as well; and that in turn necessitated deregulation of a comparison between true competitive prices and real economic costs, on the one side, and, on the other, regulated rates that may diverge widely from the marginal costs of the challenged utility company suppliers.

A business decides whether to cogenerate or not, for example, on the basis of the actual prospective incremental costs of obtaining its power in that way. Similarly, when a big buyer shops for supplies out of region, it is looking at prices set by competitive forces at something approximating marginal costs. But in making those decisions, the departing buyers compare those costs with regulated rates set to recover the local utility company’s average revenue requirements, which have a very large component of sunk, historic costs. And, as I’ve just pointed out, that overlay of inadequately depreciated historic costs, in the presence of excess capacity, produced average revenue requirements and rates in the ‘80s and early ‘90s far above the true marginal costs of the utility companies themselves. In these circumstances there was and still is no way of knowing to what extent the competition was and is efficient, to what extent inefficient.

A further distortion has been introduced by the incumbent companies’ obligation to serve, as providers of last resort to all customers, and to incur the cost, largely sunk, of fulfilling that responsibility. The introduction of competition offers buyers the opportunity to avoid those costs.

Once you begin to admit competition, it introduces strains and distortions that can typically be resolved only by further deregulation.
while continuing to enjoy the benefits by shifting to take advantage of available, competitively priced power while retaining the option of returning eventually and demanding service without penalty. So their decisions to pick up low-cost supplies elsewhere or to cogenerate may be economic only on the assumption that if the cogenerating facility fails or the cheap supplies elsewhere dry up, the buyer retains that costly-to-provide option. So, again, differential obligations of the several competitors and consequent differences in regulatorily imposed cost burdens may produce distortions in competition among them.

These distortions and strains can typically be resolved or eliminated only by extending the freedoms symmetrically to all competitors—specifically, giving the local utility companies freedom to price competitively and freedom from the continuing obligation to provide firm backup service without charge to customers who enjoy the freedom to escape the costs of providing that option. That is the historical process in which we find ourselves inevitably engaged—insevitably, that is to say, unless and until we encounter another unforeseen historic conjuncture, either specific to this industry or in the economy at large, such as occurred in the 1970s or reaching farther back, the 1930s.

Is the continuing spread of competition in generation inevitable? My answer is “Yes, probably.”

IV. The Benefits and Challenges of Competition

My description of the distortions created by partial, asymmetrical deregulation has already taken me deeply into my answer to the next question: Is competition desirable as well? My answer is “Yes, probably, but …”

I don’t have much to contribute to amplifying the first two-thirds of that answer. Experience in industry generally and in deregulated industries in particular amply supports the proposition that, wherever it is feasible, competition is superior to regulated monopoly as an institutional mechanism for producing close attention by managements to efficiency and promoting progress both in methods of production and in offering consumers an ever-expanding variety of choices, at efficient prices. And it does, indeed, appear already that the competitive generation of electric power and the prospect of its benefits becoming available to more and more customers has already (like hanging in the old adage) “marvelously concentrated the mind” of existing utility companies, subjecting them to salutary pressures to cut costs, to figure out what it is they do well and to do it and get out of doing the things that they don’t do well.

The other side of these social benefits of competition is the challenges and opportunities it poses for the utility companies—to cut costs and to compete effectively or fail. For some companies, that means leaving generation to outsiders; for others, it may mean going into generation all over the country. For all, it means finding ways of offering a variety of options and bundles of options to customers including, for example, varying degrees and conditions of reliability and interruptibility.” In doing so, the utility company serves increasingly as an assembler of services, tailor-made to meet the individual needs of individual customers.

One such package or set of packages that utilities are highly qualified to offer profitably, on a commercial, non-subsidized basis, I emphasize, is efficiency in energy use, along with kilowatt hours. Their established connections with their customers and such trust as this relationship has inspired give the incumbent companies a leg up in exploiting these opportunities. Another opportunity, likewise arising directly out of their present operations, might be to use and expand broadband networks to offer subscribers both management of their power use and telephone or other telecommunications services.
I have no way of weighing the social benefits of competition against the benefits in principle of centralized responsibility for reliability of supply, coordination of investments and operations and wholehearted cooperation, such as occurs in power pools, among non-competing, geographically separated, vertically integrated franchised monopolies. And yet the catastrophic errors of the 70s under the historic system, the apparent persistence of inefficiencies in regulatorily prescribed rate structures, which competition tends to erode, and the apparent evidence from Great Britain that a non-vertically integrated system can work all help produce my “Yes, probably” answer.

V. Adaptations of Regulation

The “but” that I have tacked on in responding to whether competition is desirable is important. It has a number of aspects.

The most important one is the necessity of adapting regulation to ensure that the competition is efficient. Competition between unregulated options (at prices equated to marginal costs) and regulated rates that diverge substantially from marginal cost provides absolutely no assurance that production will be distributed among rivals on the basis of their true economic costs and, therefore, at maximum efficiency. How then do we eliminate the distortion?

The inflation of the utility company costs and rates has two kinds of sources. One is the continuing burdens imposed on them but not their competitors to serve as suppliers of last resort; to finance regulatorily prescribed cross-subsidizations; to promote and subsidize conservation on the part of their customers and to take account of environmental costs from which their unregulated competitors are free; and any continuing requirements to contract for NUG power at inefficiently high prices. The second category is the sunk costs, the inheritance from the past, including contractual commitments to take NUG power at rates that have turned out to exceed current avoidable costs.

The first group of distortions is unequivocal and continuing and the only acceptable solution is to eliminate them, by —

- Permitting the utility to sell back-up or option demand services separately or — what comes to the same thing—require customers that want (or merely have) the option of shifting to competitors to pay separately for the right to return and demand service;
- Eliminating all artificial, regulatorily imposed requirements to continue to buy independently generated power at any rates other than avoidable costs, estimated as honestly as possible, or to subsidize energy conservation (as long as rates do not fall short of true marginal costs);
- Rebalancing rates to eliminate cross-subsidizations or taxing all suppliers proportionately to carry those costs; and
- Eliminating all environmental cost burdens that bear only on utility companies or, preferably, extending them neutrally to all sources, regulated and non-regulated.

VI. The Legacy of Sunk Costs

I suspect by far the larger source of the discrepancy between utility company rates and marginal costs is their sunk costs—running, I am informed, in the hundreds of billions of dollars—to the origins of which I have already alluded: most prominently, the very costly generating plant inherited from the 70s and early 80s and the existing contractual commitments to purchase NUG power.

Many years ago, when my wife and I first bought our house on Lake Cayuga, I made a ritual of getting in as many swims as possible during the summer—as soon as the thermometer reached 62 degrees going up and until it hit 62 degrees going down. Asked to explain this compulsion, I responded, only semi-facetiously, that the annual carrying costs of the house were so great, I wanted to spread the fixed costs over the greatest possible number of swims. When challenged by a
well-trained former student: “Didn’t you teach us that it’s irrational to be influenced by sunk costs?” I responded: “I was talking then about other people’s sunk costs; these are my sunk costs.” When the sunk costs that will be the electric industry’s preoccupation for a long time are considerably bigger than the carrying costs of my lake house and they are its sunk costs, which it is not free to ignore, I had better be very careful about preaching to utility company executives the economic irrelevance—indeed, perversity—of worrying about them.

A. The Sunk Cost Conundrum—and Some Ways Out

Beyond pointing out that economic efficiency would best be served by ignoring sunk costs and freeing utility companies to reduce their rates to marginal costs to the extent necessary to meet competition, I have no particular enlightenment to offer on the question of the companies’ entitlement to recover those presumably prudently incurred costs, a large portion of which was incurred on orders by the regulators; or on the equity or efficiency of permitting some of these costs to be shifted from escaping to captive customers (except to the extent that the latter have heretofore been the beneficiaries of cross-subsidization at the expense of the former).

But I do have several observations to urge upon utilities and their regulators with respect to the method of their recovery. First, to the extent that the incumbent electric companies are able to recover from competitors the same proportionate contribution above marginal cost as was and remains embedded in their own rates for the business that they lose to those competitors, by marking up their charges for access to bottleneck transmission and distribution facilities, there is absolutely no conflict between that recovery and economically efficient competition: All that it requires, for competitors to survive or fail depending solely on whether their marginal costs are equal to or lower than those of the incumbents, is that the utility companies incorporate that same markup over marginal costs in their own retail prices as well. Indeed, the exaction of such an equivalent contribution is not only not inconsistent with efficient competition, it is essential to ensuring that the competition is efficient while also permitting continued recovery of the stranded costs.

The frequent observation by would-be competitors and often, unfortunately, by regulators themselves that such levies “discourage competition” is at best extremely misleading. Setting aside what we might call infant company considerations—to the effect that it may contribute to achievement of the long-term benefits of competition to confer special preferences or advantages on new competitors or correspondingly special handicaps on the incumbents—an equiproportionate charge or mark-up above marginal costs for competitors and incumbent utilities alike is fully compatible with efficient competition between them.

The compatibility of such a levy on competitors and efficient competition is not dependent, in principle, upon whether they are or are not dependent upon the utility company for access to an essential facility. The latter circumstance merely determines whether it is possible to equalize competition between them in this way, while also recovering stranded costs. An electric company is hardly in a position to impose such levies on customers who are induced by the excess of rates over marginal costs to leave the state or to install insulation that they would not otherwise install. But the principle is the same: To the extent those latter decisions are induced by the excess of the utility’s price over its marginal costs, they are inefficient and, if the alternatives could be taxed proportionately, it would conduce to economic efficiency rather than the reverse. So the fact that the ability of telephone
companies to recover sunk costs and the costs of continuing, regulatorily required cross-subsidizations in their charges to competitors for access to their local networks is increasingly limited by the opportunity of competitors and their customers to bypass those facilities, quite properly, inspiring consideration of alternative methods of taxing all facilities proportionally, in order to finance at least the continuing cross-subsidization required to maintain universality of subscription. Meanwhile the best pragmatic prescription—in both the telephone and electric cases—would be to get as much of those costs back as possible, writing down the book value of inadequately depreciated plant while the getting is good.

The recovery of sunk costs in these ways, however—it is worth reemphasizing—conflicts with first-best economic efficiency because it holds prices above marginal costs. While it therefore remains fully consistent with the competition among rival suppliers being efficient, it prevents competition from achieving its other purpose of driving prices down to marginal costs.

In partial resolution of this dilemma, there is the possibility—or at least the hope—that utilities can get these costs written off, with the permission and encouragement of their regulators, to the extent there are opportunities for cost reduction that they have not yet fully exploited. If there are such opportunities, the trick for utilities will be to persuade regulators to let them keep some of the savings on condition that they use them to write off those inflated book costs. The logical—and politically attractive—way of doing so is to move from rate-of-return to pure price regulation, freezing rates in current dollars or indexing them to inflation minus some productivity factor, which is in any event superior to rate base/rate of return from the point of view of the incentives it provides for efficient operation. If, having offered the politically necessary guarantees to the captive customers that their rates will either be constant or decline in real terms, utilities could then generate excess revenues, conscientious regulators might well let them keep them, under a promise to use them to write off the sunk costs as rapidly as possible.

A third possible way out of the utilities' present impasse would be to exploit whatever opportunities that impasse itself creates. One such opportunity is presented by the excess capacity it-
nomic value was lower than book (and therefore rates based on the latter would inefficiently exceed economic cost), while continuing to value successful plant at depreciated original cost (which could produce the opposite inefficiency).

John Rowe has pointed out that the same accusation may properly be levied against competitors and customers who enter into transactions for wholesale power at market value when their utility rates exceed marginal costs, while demanding the right to use the utility companies’ transmission and distribution facilities at rates regulated on the basis of book costs. Both equity and first-best economic efficiency require that, just as the price of the power itself be driven down to marginal cost, the rates for its carriage be raised to that same target, to the extent they are at present below it.

Measuring those marginal costs of T&D is a lot easier said than done. It has sometimes been suggested, for example, that utilities try to persuade regulators to value those assets at reproduction cost. It is by no means certain that this would make economic sense—entirely apart from the familiar consideration that the proper measure of such costs would be the costs not of reproducing the present facilities but of the assets required to reproduce the services in question at maximum efficiency today. Whereas the efficient price of shoes will be at reproduction costs, because shoes are constantly being reproduced, what if some of the transmission and especially the distribution facilities are never going to be reproduced?

Clearly, the efficient price would be at marginal cost. But whether that should be short- or long-run, for small increments or measured in terms of the full marginal cost of providing the service, and how transmission losses, opportunity costs or congestion costs and their variations from one moment to the next and one part of the system to another are to be measured, are all complexities that must be mastered if this possibly promising avenue of reform is to be pursued.

I have not the slightest idea to what extent this correction of transmission and distribution charges would offset the reductions in the price of power itself required for economic efficiency; but that avenue is, I suspect, well worth pursuing.

The ultimate goal of all these regulatory adaptations would be not to avoid or prevent competition, but to get utilities out of a situation in which they are competing at an unfair handicap into one in which they can turn their full attention to the challenges and rewards for entrepreneurialism that ultimate deregulation will present.

B. Would a Sunk Cost Surcharge on Transmission be an Anticompetitive Tie-In?

In a recent decision, Cajun Electric Power Cooperative v. Federal Energy Regulatory Commission,1 the U.S. Court of Appeals for the District of Columbia Circuit overturned a FERC decision approving a transmission tariff by the Entergy Corporation that incorporated just such a surcharge or contribution as I have defended here, intended to recover from competitive suppliers of wholesale power the cost associated with investments of its own generating affiliate that would be left stranded by its loss of the power sales in question to the competitors.2 The central substantive reason for the rejection and the Court’s requirement of further FERC proceedings was its conclusion that the tariffs in question in effect involved an anti-competitive tie-in, the essence of which is the use of a monopoly position in one good or service—in this instance, Entergy’s admitted monopoly power over transmission—to require captive customers also to purchase some competitive service from the provider and in this way to foreclose competition in the offer of the tied product—in this case, wholesale electric power itself. As the Court put it:

[If a company can charge a former customer for the fixed cost of its product whether or not the customer wants that product, and can tie this cost to the deliv-
ery of a bottleneck monopoly product that the customer must purchase, the products are effectively tied as they would be in a traditional tying arrangement.9

As is so often the case, this analogy, while superficially plausible, is fundamentally inapt, for at least the following reasons:

1. In the case of authentic ties, the perpetrator in effect requires purchasers of its tying product to purchase the tied product as well, by requiring them to pay its full price. This makes it pointless for the customers to purchase that second product from competitors, provided the qualities are in all other respects equal. In short, a tie-in does indeed effectively foreclose rivals from an opportunity to offer the tied product or service in competition with the first party, even if they can do so at lower cost. In the present instance, in contrast, the charge for transmission includes only part of the (former) price of the tied product—namely, the mark-up above its costs incorporated in its previous, regulatorially approved price.

2. As a result, far from excluding competitive providers of electric power from the ability to make such sales, the incorporation of that mark-up in both the costs of the competitors—via the marked-up transmission charge—and of the incumbent utility company ensures a fair and equal opportunity for rivals to offer power, in competition in this case with Entergy’s affiliates, if they are as efficient as Entergy—

precisely as efficient competition requires.

3. Indeed, as my foregoing exposition has demonstrated, the insertion of such a surcharge in the cost of the competitors eliminates what would otherwise be a distortion of competition in their favor, so long as Entergy’s generating affiliates are required to incorporate such a mark-up in the prices they charge for their own power.

4. True, equality of competitive opportunity, on the basis of efficiency, could be ensured equally by permitting Entergy’s affiliates to reduce the prices of their wholesale offerings of power, so as to eliminate the distorting mark-up; but such a response would conflict with the obligation of the regulatory commission to give the Entergy group a reasonable opportunity to recover costs prudently incurred in fulfillment of their public utility obligations.

5. Regulatory commissions have a wide range of discretion in determining how those legitimate aggregate required revenues are to be recovered from different categories of customers. It is an extremely frequent—indeed, almost universal—practice of regulators to vary the mark-ups above and mark-downs below the costs of individual services in ways conducive to the fulfillment of other social or political goals such as ensuring to small, residential customers at least minimum supplies of these essential services at prices they can afford. It is the almost universal practice, for example, for regulators to hold the prices of basic telephone service to residential users below the costs of providing that service, requiring the utility companies correspondingly to mark-up the charges for other services, where the market will allow: this typically means, precisely as in the instant case, marking up above cost the charges to competitors for access to essential facilities controlled by the utility company—in the telephone case, for example,

Burdened with sunk costs, utilities might be forced to quit the competition.
the charges to suppliers of long-distance services for access to the local exchange network.

6. There can be no denying that the regulated company is in this way permitted to insert what might properly be called a monopoly surcharge in its rates for the bottleneck facilities under its control. But, precisely as FERC required in its Entergy decision, the size of that surcharge is subject to regulatory control and subject to the condition that it is necessary to permit recovery only “legitimate and verifiable” costs of the utility company.

7. In any event, whatever the mark-up, as my foregoing exposition has demonstrated, there can be no doubt that the requirement upon a utility company to give competitive generators access to its transmission facilities at non-discriminatory rates containing a mark-up no larger than the mark-up incorporated in its charges to its own generating affiliates does indeed “mitigate [the utility’s] market power” (the raising of “serious doubts concerning” which led the Court to return the Entergy case to FERC) in the assertedly tied product, the sale of electric power itself. And, subject to the conditions I have expounded, it gives competitors a fair, full and equal opportunity to compete in its sale with the transmission company’s own generating affiliates and to prevail in that competition so long as they are equally efficient. In these circumstances, the assertion of the Court in the Cajun case that “the petitioners would appear to be correct that the stranded investment provision is anti-competitive” is simply incorrect. It is not, as the Court there asserts, at least provisionally, “a deal killer”; unless Entergy’s would-be competitor is a less efficient producer of power than Entergy.

VII. Conclusion

The introduction of competition into the electric power industry must be reconciled with the pre-existing and continuing regulatory regime if it is to serve the rate-paying public at large well. The outcome of competition between unregulated suppliers and a utility company whose prices are still thoroughly regulated will not necessarily be determined by their respective true economic costs; it may be distorted also by the continuing obligation of utilities to provide service in accordance with their historic public utility responsibilities. Finally, it becomes necessary to reconcile that competition with the continuing entitlement of the regulated entities to a reasonable opportunity to recover their prudently incurred costs and to continue to serve their remaining customers at regulated prices.

The competition for wholesale electric customers should not be distorted by asymmetrical regulation of the competing parties if the welfare of consumers in the aggregate is to be served. This requires among other things that the rivals have the same opportunity to compete solely on the basis of their relative marginal costs of providing the service in question—in the present instance, wholesale electric power.

In situations in which prices set at marginal costs would produce revenues insufficient to give the utility a reasonable opportunity to recover its total revenue requirement—as determined by regulators—all competing sellers should make a proportional contribution to that total, as part of the price they pay for access to ultimate customers via the transmission network and/or by such other devices as may be feasible. As long as the contribution required of competitors is no greater, on a per unit basis, than the contribution reflected in the utility’s own charges to the same customers, all sellers will be in a position to compete on the basis of their relative efficiency and, indeed, will be forced to do so.

The ultimate goal is not to avoid or prevent the coming of competition. On the contrary, the goal is to promote it, while ensuring that it is efficient. Both efficient competitors and the public will be the certain beneficiaries.
Endnotes:

1. That principle requires qualification as it applies to the real world: just as a feather and a brick will fall equally fast in a vacuum—or so they say; I don’t really believe it—but not in the real world, so while society ought to abhor equally gaps both positive and negative between marginal costs and price, what it abhors especially are prices far above marginal cost. In general, only economists and environmentalists experience acute distress when the divergence has the opposite sign.

2. Effective regulation of airline prices, for example, necessitated regulation also of the commissions the carriers might pay to travel agents, their charges for in-flight entertainment, the frequency of their flights—even the size of the sandwiches they served. Similarly, deregulation of entry into individual markets soon required a corresponding lifting of the barriers in all markets, relieving incumbents of the obligation to serve, deregulation of price and of all the other inducements to attract travelers. I could tell a similar story in telecommunications.

3. I remember hearing Arno Penzian, a Nobel laureate at Bell Labs, say, “In telecommunications, it used to be that we would go to customers and say ‘Here’s what we have to offer, you choose what you want.’ Now, instead, we go to customers and say ‘What is it that you want; we will assemble it for you. We will put together whatever combination of services best meets all your needs.”

4. See, however, note 6, below.

5. In its recent notice of proposed rulemaking on the problem of stranded costs, the Federal Energy Regulatory Commission devotes much of its attention to alternative possible methods of recovering those costs. It is important that the Commission keep in mind the perhaps greater importance of the goal of keeping competition efficient. This requires that the transactions that cause or might possibly cause the stranded themselves be guided by the correct price signals. That is to say, it is at least as important from the efficiency standpoint that customers’ decisions about whether or not to desert their present requirements suppliers be influenced by the proper signals, reflecting the respective true social (i.e., marginal) costs of the alternatives, as that the utility companies be enabled to recover their regulatorily determined revenue requirements. The virtue of the mark-up on transport costs for the competitively acquired electric power is that it serves both purposes. See generally A. Kahn, The Pricing of Inputs Sold to Competitors: A Comment (with William E. Taylor), T A B J. ON REGULATION, Vol. II, No. 1, Winter 1994, at 225-40.

6. This statement is strictly correct only as it applies to static efficiency. Distributing the responsibility for supply among competitors on the basis of their current marginal costs and determining the amount of conservation buyers practice on the basis of the respective current marginal supply costs of energy and of such energy-conserving alternatives as insulation will achieve the most efficient use of existing resources at any given time. To the extent, however, that exacting from those competitive alternatives the same markups as are incorporated in the utility suppliers’ own rates (or permitting incumbents to meet all instances of threatening competition by reducing their rates selectively to short-run marginal costs: see, e.g., A. Kahn, The Economics of Regulation, Vol. 1, at 175-81) discourages the entry of such competition (or conservation) as might, while inefficient in the short-term (i.e., with short-run marginal costs higher than those of the incumbent), confer on the public the benefit of intensified competition in the longer run, the rules I have enunciated will not produce the optimum result. One version of this qualification is the case for infant industry (or company) protections. All one can say briefly about such possibilities is that any deliberate handicapping of incumbents to encourage the emergence of such competitive alternatives involves imposing certain, current costs on society in exchange for uncertain future benefits and ought not be undertaken except on the basis of an explicit and careful judgment that the future benefits, properly discounted for their futurity and uncertainty, do indeed exceed the costs and cannot be achieved merely by removing all legal barriers to competitive entry.

7. Cajun Electric Power Cooperative v. FERC, No. 92-1461, slip op. (D.C. Cir. July 12, 1994)(per curiam), 1994 U.S. App. Lexis 17001. Actually, the Court returned the case to FERC on the procedural ground that the Commission had acted arbitrarily and capriciously in accepting the tariffs without first holding a hearing on whether the open access transmission tariffs in question adequately mitigated Entergy’s monopoly power.

8. Id.

9. Id. at 9.

10. I repeat my recognition of the fact that this was not a definitive finding by the Court: it merely instructed the Commission to — address whether the ... provision of a process for recovery of stranded investment cost is itself a ‘deal killer.’... Subject to the conditions that I have enunciated, it definitely is not.

11. Supra note 7, at 12.