Regulating Public Utility Performance:
The Law of Market Structure, Pricing and Jurisdiction

Chapter Three

Authorizing Competition

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The "central, continuing responsibility of legislatures and regulatory commissions" is "finding the best possible mix of inevitably imperfect regulation and inevitably imperfect competition."[1]

Long-distance and local telephone service, wholesale natural gas supply, wholesale electric generation, retail electric and gas service, energy efficiency and demand management: All are services, historically provided by franchised monopolies, that some jurisdiction has subjected to competition. These competition experiments continue, for those services and new ones. Federal and state policymakers today are debating appropriate market structures for broadband, gas and electricity storage, distributed generation, energy conservation, "smart grid," and other new services.

A forty-year flow of statutory change, agency action and court review reveals several common steps. Each competition experiment starts with questions: For each candidate product or service, will competition be physically feasible and economically efficient? Will investors risk their dollars on the new competitors? Will competition lower prices, while increasing quality and inducing innovation? How will those benefits compare to potential losses in economies of scale and scope? How will we manage the risk that effective competition does not develop, leaving incumbents with market power in unregulated markets? These are the non-legal questions, requiring the expertise of engineers, economists, accountants, financial analysts, technologists, marketing specialists, investors, consumers and the market players themselves.

Once policymakers identify the products and services appropriate for competition, they face three main legal steps, addressed in the three chapters that follow.

Authorizing competition: The six legal features of the traditional franchised monopoly, discussed in Chapter 2, require revision for a market served by competitors. The *exclusive franchise* protected the franchisee from competition. Utilities' *consent to regulation* allowed the government to constrain the franchisee's actions without facing constitutional challenges. The *obligation to serve* and *quality of service standards* ensured that all eligible customers received satisfactory service. *Eminent domain powers* allowed the utility to take private property when necessary to serve the public. *Limited liability* protected the utility from lawsuits for ordinary negligence. Adapting these concepts to competition requires legal changes. Those changes are the subject of this Chapter.

Making competition effective: Authorizing competition does not ensure effective competition. It makes entry legal but not necessarily feasible. The policymaker still must

1. 2 Alfred E. Kahn, The Economics of Regulation: Principles and Institutions, at xxxvii, 114 (1970, 1988).

address "entry barriers"—the difference in entry cost between incumbent and newcomer. If new entrants are deterred by high entry costs, merely authorizing competition will not protect consumers from excess prices and inadequate service. (Even with effective competition, consumers still need protections against deceptive advertising, unsafe practices and indecipherable contract terms.) One type of entry barrier is a physical facility that is necessary for competition but owned or controlled by the incumbent. Examples are electric transmission and distribution facilities, gas pipelines and distribution systems, the telephone company's "last mile," and radio-frequency spectrum. Known as "bottleneck facilities" or "essential facilities," these assets cannot be economically duplicated by the new entrant, yet are necessary for market entry. Then there are non-physical entry barriers derived from the incumbent's first-mover advantage: economies of scale and scope, and customer characteristics like loyalty, inertia and shopping inexperience. The legal steps to mitigate these factors are discussed in Chapter 4.

Monitoring competition: The preceding steps change market structure by identifying products and services appropriate for competition, authorizing competitive access and reducing entry barriers. The final step, once competition has been authorized and made effective, is to monitor the market. Optimism about "competition" stimulates policy but it does not guarantee results. Not every competitor plays fair—the rational incumbent resists competition, while the new competitors can cut corners. These tendencies undermine the competitive forces freed by the prior two steps. Descriptions of these behaviors and the regulatory responses are the subject of Chapter 5.

Experience being the best teacher, we begin our three-chapter tour with brief histories of structural change in the electricity, gas and telecommunications industries.[2] We then turn to the main subject of this chapter: how policymakers have adjusted the incumbent's six legal characteristics to make room for newcomers.

3.A. Historical summary

Policymakers considering competition have wrestled with these questions: For which products and services will competition likely help the consumer? How must we revise the

2. "Brief" and "tour" are the key words. These discussions are not substitutes for in-depth study of the industries, for those who seek to specialize. Readers wishing more historic detail should consult works specific to the industries of interest. *See, e.g.*, Telecommunications Regulation Today and Tomorrow (Eli Noam ed., 1983); Warren Lavey, *The Public Policies That Changed the Telephone Industry into Regulated Monopolies: Lessons from Around 1915*, 39 Fed. Com. L.J. 171 (1987); William Byrnes, *Telecommunications Regulation: Something Old and Something New*, *in* The Communications Act: A Legislative History of the Major Amendments, at 31, 90–99 (Max Paglin ed., 1999); Richard Pierce & Ernest Gellhorn, Regulated Industries in a Nutshell (1999); Joseph Tomain & Richard Cudahy, Energy Law in a Nutshell (2011); Stuart Brotman, Communications Law and Practice § 5.01[4] (2012); Stuart Minor Benjamin, Howard A. Shelanski, James B. Speta & Phillip J. Weiser, Telecommunications Law and Policy, chs. 4–5, 8–12 (3d ed. 2012); Energy Law and Transactions (William A. Mogel & David J. Muchow eds., 2012); William A. Mogel, Regulation of the Gas Industry (2012).