

COMMENTARY

“MARKET POWER”: WHY ARE WE ASKING? A COMMENT ON “ELECTRICITY AND MARKET POWER”

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“A word is not a crystal, transparent and unchanged, it is the skin of a living thought and may vary greatly in color and content according to the circumstances and the time in which it is used.”

Justice Holmes¹

I. INTRODUCTION

Diana Moss’s excellent paper, surveying the current issues in “electricity and market power,” contains within it a certain paradox.² The core concern of the paper—market power—is nowhere defined.

An initial response to this observation might be that the

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1. *Towne v. Eisner*, 245 U.S. 418, 425 (1918).

2. Diana Moss, *Electricity and Market Power: Current Issues for Restructuring Markets (A Survey)*, 1 ENVTL. & ENERGY L. & POL’Y J. 11 (2006).

paper also doesn't define "electricity," certainly another core concern of the paper. Why single out the failure to define "market power" for paradoxical treatment?

The answer is, I think, that electricity, and electric power, are real. They are physical phenomena, which can be felt (quite literally) and measured. Market power is not real. Market power is an analytical concept, grown in the soil of political economy, and used to describe certain concepts and to achieve certain policy results.

That we can barely talk about either antitrust or regulation today without mentioning "market power" is a tribute to the power of this concept to organize our thinking. Each of us can probably easily supply a working sense of what we think the term means. The burden of these comments, however, is to show how shifting that sense can be, depending on context, and how the too easy lifting of the concept from one area to another may mask important policy effects. I think this is particularly true when lifting the concept of market power from antitrust to electric power regulation.

My comments are divided into three parts. First, I explore the different contexts where market power is employed in antitrust, a far briefer "stock taking" exercise than Diana Moss' review of market power issues in electric power regulation. Second, I suggest how the use of the term in electric power regulation may be diverting policy analysis from deeper institutional issues that are at the heart of today's regulatory problems. I conclude with some brief observations on the importance of institutional design.

II. JUDICIAL USE OF MARKET POWER

Judicial use of the concept of market power in antitrust cases came out of a common-sense observation about the power of a cartel involved in price fixing "to control the market and to fix arbitrary and unreasonable prices."³ The concept was subsequently used more abstractly in antitrust cases. Monopoly power was used to refer to the power to control prices or exclude competition.⁴ Later, the term market power was described in

3. United States v. Trenton Potteries Co., 273 U.S. 392, 397 (1927).

4. United States v. E. I. Du Pont de Nemours & Co., 351 U.S. 377, 391 (1956). For a discussion of the question whether there is, or should be, a difference between "market power" and "monopoly power," see Thomas G. Krattenmaker, Robert H. Lande, & Steven C. Salop, *Monopoly Power and Market Power in Antitrust Law*, in REVITALIZING ANTITRUST IN ITS SECOND CENTURY: ESSAYS ON LEGAL, ECONOMIC, AND POLITICAL POLICY 175 (Harry First, Eleanor M. Fox, & Robert Pitofsky, eds. 1991) [hereinafter

antitrust cases by statements such as, “as an economic matter, market power has been said to exist whenever prices can be raised above the levels that would be charged in a competitive market,”⁵ or “market power [is defined] as ‘the ability to cut back the market’s total output and so raise price.’”⁶

But whatever the formulation used by the courts, the concept has always retained a certain fluidity. What is meant by “control” of price? When does a seller have the “ability” to control output? What power is enough to “exclude competition”? If we are to use the “economic approach,” how do we tell what prices would be charged in a competitive market when the definition, itself, refers to another vague and undefined concept, a “competitive” market? Indeed, how certain can this term be when the definition of “market” is, itself, uncertain?

The very fluidity of the term “market power” may be annoying to economists, who would prefer something expressed in quantifiable terms (the Lerner Index, for example), but it is not surprising that the courts have not pinned down the term. Law is accustomed to dealing with vague standards, “reasonableness,” for example.⁷ Indeed, the courts have never found that a defendant has “market power” simply from proof that the defendant was pricing above the competitive price (or above marginal cost), but that is because market power is a judgment, not an objective fact. What may be surprising is our willingness to act as if this vague term isn’t vague at all.

Indeed, despite the inherent vagueness of the term, the concept does some very important work for antitrust. First, it is used to help sort cases that do not seem to raise much concern from a competition point of view. If market power is lacking, market forces should discipline any effort to raise prices. Second, and implicit in the first, it directs the courts to focus on, and to remedy, bad conduct that is likely to be somewhat long-lasting and not transient. A direction to find market power is a direction not to waste judicial enforcement resources on restraints that will fix themselves more quickly than litigation can. Third, if we conclude that the defendant has market power, with the

REVITALIZING ANTITRUST] (arguing that both concepts refer to the “same phenomenon,” that is, the ability to price above the competitive level, but that market power can be exercised in two different ways).

5. Jefferson Parish Hospital Dist. No. 2 v. Hyde, 466 U.S. 2, 27 n.46 (1984).

6. United States v. Microsoft Corp., 253 F.3d 34, 51 (D.C. Cir. 2001), cert. denied, 534 U.S. 952 (2001) (quoting Ball Mem’l Hosp. v. Mut. Hosp. Ins., 784 F.2d 1325, 1335 (7th Cir. 1986)).

7. See Louis B. Schwartz, *The Dangerousness of Power*, in REVITALIZING ANTITRUST, *supra* note 4, at 250.

implication of possible non-transient adverse effects, courts may be able to shift to the defendant the burden of proving an efficiency justification. Such burden shifting plays an important role in today's antitrust jurisprudence.

The varying antitrust approaches toward market power are summarized in Table 1.

Type	Need to Prove	Type of Proof In Court	Competitive Concern	Government Remedy
Monopolization	yes	market share; strong entry barriers	exclusionary conduct; high prices sometimes	restructuring; injunction
Mergers	yes	HHI; weak entry barriers	future price increases	spin offs; injunction
Horizontal Restraints	Sometimes	market share or direct proof of effects	price increases; exclusion	injunction; criminal penalties
Vertical Restraints	almost always	market share and/or direct proof of effects	exclusion; raising rivals' costs	injunction

Table 1. Market Power in Antitrust Cases

Table 1 shows that the deployment of the concept of market power varies along a number of dimensions. Market power is not always required, not always proved the same way, and not subject to identical treatment with regard to entry barriers. For example, the federal agencies' merger guidelines define market power as "the ability profitably to maintain prices above competitive levels for a *significant* period of time" (emphasis added).⁸ The Guidelines' entry analysis, however, focuses on the likelihood of competitive entry within a two-year period and, at least in some cases, appears to shift the burden to the defendant to prove ease of entry.⁹ In monopolization cases, by contrast, there is no formal requirement that a monopoly be durable, although most monopolization cases involve durable monopolies, and there is a stated burden on the plaintiff to prove that entry barriers are "substantial."¹⁰ In horizontal price fixing cases, the only type of antitrust restraint for which imprisonment is likely

8. United States Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, §§ 0.1, 3.2 (1994), available at <http://www.usdoj.gov/atr/public/guidelines/hmg.htm>.

9. See *id.* § 3.2.

10. *E.g.*, *Microsoft*, 253 F.3d at 81.

today, there is no requirement that market power be proved. For those horizontal restraints where proof of market power is required, courts have allowed what they call “direct” proof of anticompetitive conduct instead of proof of structural market power. The courts in these cases describe market power as simply a “surrogate” for proving detrimental effects to competition, specifically, higher prices and reduced output; proof that the restraints have led to higher prices can replace a requirement that the plaintiff prove any durable power to make the higher prices stick.¹¹ By contrast, in vertical distribution cases, courts have often set a high threshold for proof of market power, shown great tolerance for relatively short-term restraints, and have even rejected “direct” proof of the exercise of market power in the absence of structural proof that the defendant had market power.¹²

If further demonstration were needed that market power is not treated as a unitary concept across antitrust, that proof can be found by looking at how courts treat monopolization. The obvious point is that the possession of monopoly power by a monopolist is perfectly lawful. More curiously, perhaps, the actual exercise of market power—that is, the increase of price above the competitive level—is also lawful. Consider Justice Scalia’s statement in *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko, LLP*: “[T]he . . . charging of monopoly prices . . . is an important element of the free-market system. The opportunity to charge monopoly prices—at least for a short period—is what attracts ‘business acumen’ in the first place; it induces risk taking that produces innovation and economic growth.”¹³

Of course, it is not really paradoxical that market power is used differently depending on the context. Different antitrust violations are directed at different problems and are remedied in

11. See, e.g., *FTC v. Indiana Federation of Dentists*, 476 U.S. 447, 461 (1986) (quoting 7 PHILLIP E. AREEDA, *ANTITRUST LAW* ¶ 1511, at 429 (1986)).

12. See, e.g., *United States v. Dentsply Int’l*, 277 F. Supp. 2d 387 (D. Del. 2003) (rejecting claim under Sherman Act, Section 1, and Clayton Act, Section 3, relating to exclusive dealing contracts; even though defendant had high market share, alternative channels of distribution were available and exclusive agreements were terminable at will by distributors), *rev’d on other grounds*, 399 F.3d 181 (3d Cir. 2005) (finding violation of Section 2). On proof of market power through direct effects in vertical cases, see *Republic Tobacco Co. v. North Atlantic Trading Co.*, 381 F.3d 717 (7th Cir. 2004). The case has been criticized, see Andrew I. Gavil, *A Comment on the Seventh Circuit’s Republic Tobacco Decision: On the Utility of “Direct Evidence of Anticompetitive Effects”*, *ANTITRUST* Spring 2005, at 59.

13. *Verizon Communications Inc. v. Law Offices of Curtis V. Trinko*, 540 U.S. 398, 407 (2004).

different ways. We can allow “direct” proof of market power in horizontal cases because those cases seek to enjoin the continuation of collusive conduct, whose adverse competitive effects have already occurred. Monopolization, by contrast, is directed at remedying the behavior of a single firm whose dominant position often reflects efficient conduct, at least to some degree. If courts are not asked to restructure the monopoly firm, but are simply asked to condemn a monopoly firm for pricing “above the competitive level,” an appropriate remedy would require continual monitoring of the monopolist’s prices until it no longer had the power that enabled it to charge such prices. This type of oversight, of course, is said to be the job of regulators, not the courts.

III. REGULATORS AND MARKET POWER

Historically, regulators of electric power, and other industries thought to be natural monopolies, have been given the job of overseeing the pricing of durable monopoly firms that we are not going to restructure and that are able to charge prices above the competitive level. The traditional tool for this job was cost-of-service ratemaking, used under a legal standard requiring that rates be just and reasonable.

Traditional cost-of-service rate regulation has long been criticized, of course, for being unduly burdensome, for skewing investment incentives, and for not doing a good job of controlling pricing in any event.¹⁴ This critique of traditional rate regulation for electric utilities, coupled with technical and economic changes in the way electric power can be generated and transmitted, has helped fuel an effort to move away from this form of rate regulation for electric utilities. But the movement away from traditional rate regulation is also the result of a broader political critique of government regulation and a growing political preference for private solutions free from government control.

It is in this economic and political context that today’s electric utility regulators use the concept of market power. As with antitrust, it should be no surprise that the meaning and use of the term is contextual. Two examples can be taken from Diana Moss’s paper.

14. The costs and problems of cost-of-service ratemaking are well-explored in ALFRED E. KAHN, 1 THE ECONOMICS OF REGULATION: ECONOMIC PRINCIPLES 20–57 (1970). The classic critique of the utility of electricity rate regulation is George J. Stigler & Claire Friedland, *What Can Regulators Regulate? The Case of Electricity*, 5 J. L. & ECON. 1 (1962), criticized in George L. Priest, *The Origins of Utility Regulation and the “Theories of Regulation” Debate*, 36 J. L. & ECON. 289, 321–22 (1993).

One is the Federal Energy Regulatory Commission’s (FERC) ongoing effort to construct “generation market power screens” that will identify when wholesale sellers of electric power are given market-based rate authority or, alternatively, when they are subject to closer rate regulation. In the 1980s, FERC began to free utilities from close price controls by allowing firms that lacked generation market power to sell electricity at “market-based rates.” Market power was based on market share of “installed and uncommitted generation in a particular market” and was set at twenty percent of the market.¹⁵ In 2001, FERC replaced this approach with a “supply margin assessment” screen, intended to determine when an electricity seller was “pivotal in the market,” that is, when at least some of the seller’s capacity “must be used to meet the market’s peak demand.”¹⁶ In 2004, FERC replaced this approach with an “interim” approach adopting two separate “indicative” screens for market power, a “pivotal supplier” analysis, based on annual peak demand, and a market share analysis, applied on a seasonal basis.¹⁷ The market share analysis returns to the twenty percent threshold figure (relying on Justice Department Merger Guidelines).¹⁸ Under the interim approach, however, this assessment is apparently only a start. Sellers that flunk one of the screens can go further and provide a “more robust study” of market power (the “delivered price test”); on the other hand, buyers can rebut the presumption by providing studies of historical wholesale sales prices or historical transmission usage by alleged competitors, presumably to show what has actually happened in the market.¹⁹ This approach is an interim one, however, because FERC simultaneously announced an ongoing generic rule making proceeding to study how to measure and assess market power.²⁰

The second example is the description of physical and economic withholding as a species of market power. An illustration of how this concept is used can be found in the regulations of the New York Independent System Operator (NYISO). The NYISO has adopted “Market Power Mitigation

15. Order on Triennial Market Power Updates and Announcing New, Interim Generation Market Power Screen and Mitigation Policy, 97 F.E.R.C. ¶ 61,219, at 61,969 (2001).

16. *Id.*

17. Order on Rehearing and Modifying Interim Generation Market Power Analysis and Mitigation Policy, 107 F.E.R.C. ¶ 61,018, at 61,054–55 (2004).

18. *Id.* at 61,066 n. 86.

19. *Id.* at 61,055.

20. See Initiation of Rulemaking Proceeding on Market-Based Rates and Notice of Technical Conference, 107 F.E.R.C. ¶ 61,019 (2004).

Measures” under which it will impose “mitigation” for bidding conduct that “would not be in the economic interest of the Market Party in the absence of market power.”²¹ Market power, however, is never directly defined. Instead, market power is defined by categories of conduct, which are then defined. So, “economic withholding,” a category of conduct warranting mitigation as an exercise of market power, is defined as “submitting bids for an Electric Facility that are unjustifiably high so that . . . the bids will set a market clearing price.”²² Bids are unjustifiably high if they exceed, by various specified amounts, various designated “reference levels”; these reference levels could be the bidder’s own prior bids, bids of competitors, bids cleared in advance by the NYISO, or the NYISO’s “estimate of the costs or physical parameters of an Electric Facility, taking into account available operating costs data, appropriate input from the Market Party, and the best information available to the ISO.”²³

Looking at these two examples of “market power” one might ask whether the use of the concept of market power makes sense. Does a seller with only twenty percent of any defined market really have market power? No antitrust court would ever so hold. Indeed, twenty percent certainly makes no sense if it is based, as FERC says, on a threshold that the Justice Department articulated for considering whether to challenge a merger on potential competition grounds (the twenty percent refers to the share of the market held by the firm inside the market).²⁴ Or one might ask whether it makes sense to say that a bidder is abusing its “market power” when it decides to ask a very high price in the hope that this price will clear the market and lift all other prices along with it. One wonders what goes on in real estate markets, or grain markets, or securities markets, where bidding strategies are presumably employed routinely in an effort to get the highest price possible. Are all of these strategies examples of the use of market power?

The only way to make sense of these uses of the term

21. New York Independent System Operator, Inc., FERC Electric Tariff, Original Volume No. 2 Attachment H, ISO Market Power Mitigation Measures, § 2.3 (b), Fifth Revised Sheet No. 467, Superseding Fourth Revised Sheet No. 467, (effective date 2/1/05), available at http://www.nyiso.com/public/webdocs/documents/regulatory/filings/2005/01/atthmnt_1_srvcs_atthmnt_h_clean.pdf.

22. *Id.* § 2.4 (a) (2).

23. *See id.*, §§ 3.1.2 (threshold levels), 3.1.4 (reference levels).

24. FERC referred to § 4.134 of the U.S. Department of Justice 1984 Merger Guidelines, *see* Order on Rehearing and Modifying Interim Generation Market Power Analysis and Mitigation Policy, 107 F.E.R.C. ¶ 61,018, at 61,066 n.86 (2004). The Justice Department now calls these guidelines “Non-Horizontal Merger Guidelines,” *see* <http://www.usdoj.gov/atr/public/guidelines/2614.htm> (last visited May 31, 2005).

“market power” is to pose this question: Why are we asking? FERC is asking the market power screen question to decide when it needs to be even involved more actively in rate regulation.²⁵ Firms that fail the market screens then face either “default cost-based rules” or cost-based rules that the regulated company proposes supported by its own cost studies.²⁶ The NYISO is asking the abuse of market power question in the context of economic withholding to make sure that electric prices bid into the NYISO’s market on an on-going basis are not too high in the sense that they are too far out of synch with the bidder’s costs. Market power is not the issue; high consumer prices are the issue.

The question then should be: Why ask one question when you want to answer another?²⁷ Does it help the analysis to refer to “market power” when the concept is, in itself, vague and its usage highly contextualized? If “market power” does some specific work in antitrust, what work can it do for regulation?

One answer lies in political economy. Looking for abuses of market power may be something of a regulatory effort, but the task at least appears to be deregulation-oriented, implying that the government is limiting its actions to correcting market abuses rather than regulating market conduct. This is a much more palatable form of government intervention.

Even if the use of “market power” is good politics, it does not necessarily lead to real deregulatory effort or to good results. For one, the effort to define and police “market power” today has turned into its own, potentially burdensome, regulatory exercise. For another, the use of the term can easily lead to false analogies if regulators simply lift the term out of context. A small example of that is FERC’s reliance on Justice Department *Merger Guidelines* for potential competition mergers, guidelines which would appear to have nothing to do with the regulatory question

25. See Reporting Requirement for Changes in Status For Public Utilities With Market-Based Rate Authority, 110 F.E.R.C. ¶ 61,097 (2005). I use “more actively,” because even companies with “market-based rate authority” will still be subject to continuing pricing oversight.

26. See 107 F.E.R.C. ¶ 61,018, at 61,055 (stating that the “default rates” would be: “(1) sales of power of one week or less must be priced at the applicant’s incremental cost plus a ten percent adder; (2) sales of power of more than one week but less than one year must be priced at an embedded cost “up to” rate reflecting the costs of the unit or units expected to provide the service; and (3) new contracts for sales of power for more than one year must be priced at a rate not to exceed embedded cost of service and the contract must be filed with the Commission for review.”).

27. FPC v. Hope Natural Gas, 320 U.S. 591, 647 (1944) (Jackson, J., concurring in the judgment) (“Why did courts in the first place begin valuing ‘rate bases’ in order to ‘value’ something else?”).

FERC was considering. A reverse example can be found when courts subsequently review regulatory references to “market power” and treat the term as if it is being used the same way it is used in antitrust cases. So in *Edison Mission Energy, Inc. v. FERC*, the D.C. Circuit vacated FERC’s approval of the NYISO’s provisions for automatic mitigation in economic withholding situations because the procedure did not distinguish between high bids that are the result of “scarcity” and high bids that are the result of “market power.”²⁸ The court, of course, never defined what *it* meant by “market power,” but it made clear that it thought that the suppression of high bids in the face of scarcity was bad policy because “suppliers who could otherwise profitably enter will be deterred from entry.”²⁹ This is standard antitrust thinking, but the NYISO’s rules, of course, are not directed at structural market power as antitrust knows it, and so little attention was paid to conditions of entry, which deal with a more long-run phenomenon than the electricity price-spikes the NYISO was confronting. Had the NYISO not lost its way in the language of “market power,” but had it instead looked directly at the question of when bids are simply too high (not “just and reasonable,” to use the old regulatory standard), its procedures for automatic mitigation might have been upheld by the court.

The use of the term “market power” can thus end up masking what regulators are actually doing, which is regulating price. Price regulation is not necessarily bad, but failure to understand that the “market power” concept is being used as a tool for price regulation can lead to bad results, not only in the courts, but in the regulatory process as well. It may ultimately divert regulatory attention from the critical bottom line question—is the regulatory agency doing a good job of price regulation, better, say, than no regulation at all?

IV. CONCLUSION

In important respects regulation and antitrust complement each other.³⁰ Both have a core mission of getting price in line with cost. Both need to pay attention to incentives for innovation.

But the two approaches use somewhat different institutional designs to achieve their goals. Antitrust hopes for minimally

28. *Edison Mission Energy, Inc. v. FERC*, 394 F.3d 964 (D.C. Cir. 2005).

29. *Id.* at 969.

30. A point well made by Darren Bush & Carrie Mayne, *In (Reluctant) Defense of Enron: Why Bad Regulation Is to Blame for California’s Power Woes (or Why Antitrust Law Fails to Protect Against Market Power When the Market Rules Encourage Its Use)*, 83 OR. L. REV. 207 (2004).

intrusive intervention, after which “markets” will work again.³¹ Regulation assumes that intervention needs to be more continuous. When antitrust sets high thresholds for market power, or does not do anything about its exercise, it has often done so for institutional design reasons, whether correctly or not is another matter. This does not mean there is no reason for intervention, just that courts believe they lack institutional competence.

The real question for electric utility regulation is whether regulatory agencies can take advantage of their institutional comparative advantage—in-depth knowledge of an industry. Putting regulatory intervention through the sifter of “market power” won’t tell us much about whether regulatory supervision will have that comparative advantage unless the term “market power” is used carefully. In the end, the question is not whether electric generating companies have market power but how the participants in electricity markets are behaving and whether regulatory intervention has made a positive difference.

31. There are, of course, important examples of ongoing judicial decrees in antitrust litigation, involving technically difficult issues. *See, e.g.*, *United States v. Microsoft Corp.*, 2002 U.S. Dist. LEXIS 22864 (D.D.C. 2002) (final judgment), *aff’d*, *Massachusetts v. Microsoft Corp.*, 373 F.3d 1199 (D.C. Cir. 2004). Status reports on administration of the Microsoft decree are posted at http://www.usdoj.gov/atr/cases/ms_index.htm (last visited July 20, 2005).