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IS BIGGER BETTER?

Honorable Richard Cudahy

It's a pleasure to be here today to talk about the elements of an effective competition policy. It is interesting that this subject of competition has risen to the head of the list of all the things that are important in electricity today. It was only about a year ago that I was invited to go to Brazil by the OECD, the Organization for Economic Cooperation and Development, to preach the gospel of competition to the judges of Brazil. This is part of a program by that organization to try to develop and stimulate an understanding of competition in developing countries as a crucial factor in economics and law. Since judges, as you know, are pretty slow to learn anything new, they thought they needed a judge along to wake up the brethren in Brazil. If I put them to sleep instead, I apologize. Not long after the Brazil junket, I attended a program at the University of Houston, which focused on market-based rates and the various tests and screens that had been devised by the FERC as the basis for authorizing them (hub and spoke, supply margin, pivotal supplier, and so on). One of the most interesting aspects of that problem, it seemed to me, is the view that there isn't any test whose precision is beyond question (even delivered price analysis—the merger test), and the regulatory agencies may have to settle for an approximation. The issue then becomes: how does an approximation square with the statutory requirement that rates be just and reasonable? Is it all right for them to be *approximately* just and reasonable? That is one of those fun questions that we judges may get a chance to answer.

Despite the focus of today's program on competition, and the placement of that subject as Number One on the regulatory "Hit Parade," I am going to address most of my remarks to what I think is the most significant trend in the electric power industry today—and that is consolidation—because that is the difficult context in which competition has to be viewed. There was a great deal of speculation prior to the repeal of the Public Utility Holding Company Act—let's call it PUHCA—about whether this would bring on a huge wave of mergers in its wake or whether this concern was overblown. Frankly, I think the original reaction was the correct one. I think a powerful process of consolidation in the electric power industry is under way and there are practically no limits to where it may lead us. Of course, long before the repeal of PUHCA, the prospect and reality of deregulation helped to produce 57 mergers of electric power companies between 1995 and 2001. All that PUHCA repeal did was to signal to the industry that the policy of the country was no longer hostile to consolidation but had become downright friendly.

If one doubts the potential here, I would invite your attention to the railroad industry. The last time I looked, there were two surviving railroad systems in the eastern part of the country—CSX and Norfolk & Southern—and two surviving railroad systems in the west—Burlington Northern Santa Fe and Union Pacific. The only thing that is apparently still verboten is the creation of a coast-to-coast railroad system, which had been the goal of railroad reorganizers since the days of Jay Gould. When the Burlington Northern and the Canadian National proposed a merger, which would have at last resulted in a coast-to-coast situation, the Surface Transportation Board finally threw up its hands and called for the formulation of new merger rules and a moratorium on merger activity for a period of fifteen months. As a result, the Burlington-Canadian National proposal was withdrawn. The new rules, when issued, emphasized competition. So, there is still a way to go, even in the railroads. So what is the final resting place for the electric utility industry? Fifty systems? Ten systems? Five systems? Two systems? I can only conjure up the ghost of Samuel Insull to help suggest all the possibilities here.

Now there are different aspects to consolidation, some of them pluses and others minuses. The first plus is the prospect of integration, meaning the combination of several into one as a single operating unit. Integration was, of course, favored by PUHCA, which excepted from its death sentence consolidations which resulted in integration of electric operations. And this is an exception, which, of course, made excellent common sense. Since time immemorial it has been thought beneficial and in the interest of efficiency to integrate the operations of adjacent utilities, and, for that matter, this is what power pools are all about. And even the Supreme Court thinks well of the principle of electromagnetic unity of response.

Another rather obvious benefit of consolidation in the industry is enhanced reliability. Reliability has, to some extent, been undermined by deregulation and competition, and it has suffered from a period of neglect while other things were emphasized; however, it seems more than likely that the placement of larger areas and longer lengths of transmission lines under a common management will provide benefits for reliability. Reliability, instead of having to depend heavily on the performance of operators external to the system in question, will be an internalized concern of an expanded system. There are also specialized benefits of consolidation, such as the placing of an array of nuclear plants under the management of a system with a demonstrated capability in nuclear generation. The present merger of Exelon with Public Service Enterprise Group has relied heavily upon the benefit of bringing more nuclear generation under a management skilled in this specialty.

It has always seemed to me that the balkanization of the electric power industry in the United States was one of the major factors contributing to the failure of nuclear power in this country. The construction, and to a lesser extent the maintenance, of nuclear power plants is a challenge that is likely to be met more successfully by the concentration of engineering and other resources in a large system than by their diffusion in many small systems. These are some solid pluses of consolidation, which cannot be gainsaid even if, with respect, for example, to competition, there may be minuses.

Of course, there are two general types of consolidation. There is consolidation offering the broadest opportunity for integration, namely the consolidation of contiguous utilities. On the other hand, there is the sort of consolidation pursued by the old holding companies and virtually prohibited by PUHCA, namely the joinder of non-contiguous utilities such as that recently proposed by Constellation Energy and Florida Power and Light Company, where the members of the combination do not have a common service area boundary. These combinations do not seem to offer the same opportunity for integration as that between contiguous utilities, but there is still the ostensible benefit of a larger and more expert operating and engineering staffs available to all facets of the operation. The qualities of contiguous and non-contiguous combinations have been modified somewhat by the existence of large numbers of merchant plants controlled by the parties to the combination, which may be operating in far-flung corners of the nation. We can see this aspect in the analysis by the FERC of the Exelon-PSEG merger as it focused on competition in ERCOT—ERCOT in Texas being a long way from New Jersey, Pennsylvania and Illinois. Nonetheless, in general it would be fair to say that the competitive problems presented by non-contiguous mergers are less obvious than the ones presented by the merger of contiguous utilities. And, of course, the impact on competition is perhaps the most obvious negative aspect of consolidation. But, I would caution you that it is all too easy to forget the palpable benefits of economies of scale, scope and density and other operating benefits to be derived from consolidation in one's concern about what is going to happen to competition.

Of course, the regulatory agencies and the Department of Justice are proceeding on the thesis that competition can be maintained in the face of consolidation by a careful analysis of concentration ratios in various markets and the like. But I think it is axiomatic that, speaking in broad generalities, consolidation is not helpful to competition. Competition may continue to exist between consolidated empires, but, instead of being like the competition of corner grocery stores, it has become like the competition between Bethlehem and United States Steel in the glory days of the steel industry. However, I would again caution you today not to assume that competition will emerge the winner in a battle with consolidation. The forces driving consolidation, particularly its aspect of integration, are such that these goals will be pursued even if, by pursuing them, competition flags. It is not my purpose today to try to persuade you that integration will produce a healthier industry or may be a greater benefit to the consumer than competition. However, I think that integration is a very easy concept to understand, and that its benefits would seem obvious to casual observers. Competition in the electric power industry, on the other hand, is a process whose benefits have yet to become obvious to the average observer or to the average consumer. It is doubtful how many members of the public would feel a sense of loss if, in the onward march of consolidation and integration, competition lost its edge. If the ongoing development of the electric power industry becomes a struggle between the values of integration and the values of competition, I am not sure I would put my money on competition.

Now, there is a very important factor that I have not taken account of in this analysis. In the days of the holding companies, that is in the 1920s and early 1930s, one of the most potent political battle cries emerging against them was the concern about the creation of what was called the "power trust." This was in the period, of course, when large combinations of business enterprises had been organized and were known as "trusts." There was wide public concern

about the creation of trusts in any line of business, not so much because these mammoth organizations would be technically unfriendly to competition, but simply because they represented huge aggregations of capital that would be difficult to control in the public interest. The “power trust” was the appellation conferred upon massive aggregations of political and economic power by the providers of electric power (no pun intended); therefore, it is likely that, if the electric power industry becomes as concentrated as I anticipate it might, there will be broad concern about a re-concentration of economic and political power that may not be relied upon to function in the public interest. Now, there are two ways of dealing with trusts. Either one may break them up, or one may try to regulate and control them. In any coming concentration of the electric power industry, I do not see regulatory agencies equipped to deal with the kind of economic and political power aggregated in a consolidated industry. Hence, if the powers of regulation are not significantly enhanced, I do not see measures short of the re-enactment of PUHCA, which is most unlikely, coming into place to deal with a new “power trust.” Perhaps, however, public antipathy to the recreation of a “power trust” in this country might serve to strengthen the forces working to support the survival of competition in what I would call the technical sense, with which this conference is concerned. As you can see, there are many currents and cross-currents at work in the intersection of consolidation with competition. This will be a crucial area of attention in the years ahead.

What I am saying, I believe, can be summarized in this fashion. The movement toward consolidation in the electric power industry is a very powerful one, and one consolidation tends to lead to another, as has been demonstrated in the railroad industry, in the banks and in a great many other industries that used to be called “regulated.” This trend is, first of all, the result of deregulation—of the casting aside of regulatory constraints, which formerly tended to reduce the risk under which regulated companies operated. There was little risk of failure among regulated organizations that operated in a non-competitive environment. But, once the factor of deregulation was introduced, the companies involved developed a much more palpable sense of risk, of the possibility of failure, and their thoughts immediately turned to consolidation as a means of diminishing risk—and of achieving greater control of the market. Control of the market is, of course, something that antitrust is designed to prohibit, so there is this continuing tension between the drive for consolidation and the efforts to maintain keen competition.

In general, one consolidation leads to another as companies look over their shoulder to see who is becoming bigger than they are, and there is intense competition in the process of consolidation itself. Now, up to a point, competition and consolidation may be accommodated by the sorts of measures, such as divestiture of assets, virtual divestiture and the like that are typically attached as conditions to mergers. I would call these technical measures. They make possible competition in detail, but whether the over-all environment enhances or devalues competition, I think, is another question. And, I think one would have to concede that, in the big picture, a broad trend toward consolidation is not consistent with heightening competition. So, if that were all there was to the problem, one might expect that consolidation would eventually succeed in tempering the forces of competition. I am not expressing a value judgment of that sort of development. I would think that, among most of those present here, it would not be a welcome trend. However, I am inclined to think that, once started, there is practically no limit to

the process of consolidation.

The one factor that does not enter into this analysis is the likelihood that consolidation will give rise to something resembling the “power trust” of the Insull era. Then, there may be general concern about the political and economic power of the mammoth concerns owning and controlling large sectors of a crucial infrastructure. This is an aspect of industrial organization that at one time was thought to be an objective of the antitrust laws generally. But in recent years, the focus of the antitrust laws has been strictly on the maintenance of market competition rather than on the disciplining of giant enterprises. In electric power, this is a development that can be met only by stronger regulatory forces than are in existence today.

So, I think we have much more here to be concerned about than the maintenance of competition at a what I would call a technical level. We are in the throes of a powerful restructuring of the industry along lines of consolidation, and, as I have suggested, I think this is really the dominant movement at work in the electric power industry today. I don’t think we can carry on any discussion of the technical aspects of competition without understanding the dynamics of consolidation, which, I think, may ultimately overpower everything else, or at least fundamentally change the dimensions of other problems. Consolidation of the industry may call for more pervasive and much more powerful regulatory forces. In any event, I am looking forward to enlightenment on this and related subjects as we continue this interesting exchange.

Thank you.