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REAL-TIME PRICING: LESSONS FROM *TRIGEN V. OKLAHOMA GAS & ELECTRIC*

Trigen v. Oklahoma Gas & Electric sends a warning to electric utilities to monitor their sales practices. Plaintiff Trigen alleged that Oklahoma Gas & Electric (OG&E) used predatory sales practices to monopolize the market for cooling services in downtown Oklahoma City. The jury found in favor of Trigen and awarded antitrust damages and punitive damages totaling over $27 million.

An OG&E representation about its real-time pricing (RTP) was a central issue at trial. RTP is simple in theory: retail electricity buyers pay the incremental cost of electricity on an hourly basis. In practice, however, RTP is more complicated. To begin, prices are not in "real" time. To give buyers time to plan electricity usage, real-time prices are usually day-ahead prices or week-ahead prices. The utility forecasts prices for one day and one week and buyers purchase at the forecast prices. This creates risk for the utility that is usually passed on to the customer in the form of a "risk recovery factor" (RRF) charge. The RRF and other adjustments often result in prices above incremental costs during low-cost hours and below incremental costs during high-cost hours.

In the spring of 1996, OG&E approached Trigen's customer, Oklahoma City, with an RTP offer. OG&E represented that its pilot RTP rate would allow it to supply electricity to a new cooling plant at an average price of 1.8 cents per kilowatt-hour. OG&E's representation was seriously flawed. Even if one accepted OG&E's supporting data, OG&E could never have delivered electricity at an average rate of 1.8 cents. Like other utilities, OG&E charges customers an RRF to compensate OG&E for the risk from day-ahead and week-ahead prices. The average of 1.8 cents, however, was based on hourly data for week-ahead pricing without the RRF that Oklahoma City would have paid if it chose week-ahead pricing. Under the terms of the RTP tariff, OG&E could not legally deliver electric energy at the price it represented. Correcting for this mistake and others (i.e., the historical basis for pricing and omission of the customer load profile) would have increased the actual price by 71 percent. If RTP prices turned out to be higher, as they likely were during the heat wave and price spikes of 1998, actual prices would have been even higher. The jury apparently found that these facts, among others, showed the predatory intent of OG&E's actions.

Another issue–one that was not specifically addressed at trial–is that RTP may make it profitable for an electric utility to sell to a competitor. In the instant case, OG&E may have increased its profits by selling to Trigen rather than serving Oklahoma City directly. RTP tariffs are often structured so that a utility is guaranteed to make money when supplying energy during low-cost hours and to lose money during high-cost hours. By selling to Trigen, OG&E would still have made sales and profits during the low-cost hours. During the high-cost hours, however, Trigen could have shifted its chiller load from electricity to lower-cost natural gas. RTP would not have been used during the high-cost hours, and, consequently, OG&E would have suffered fewer losses. The profitability of this scenario compared to selling to Oklahoma City directly

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depends upon the price level at which incremental sales reduce profits and the price level at which Trigen would switch from electricity to gas. Were it more profitable for OG&E to sell to Trigen, it would affirm the predatory intent of OG&E deferring its decision regarding sales to Trigen until Oklahoma City had committed to building its own cooling plant.

Restructuring, deregulation, and increased competition have brought about many changes for electric utilities. *Trigen v. OG&E* demonstrates some of the litigation risks created by a more competitive environment and the importance of proper sales practices.

Vice President John R. Morris has studied competition in the natural gas and electric utility industries. He testified on behalf of Trigen in Trigen v. Oklahoma Gas & Electric. *He previously was a manager, advisor and staff economist at the Federal Trade Commission.*

THE UNION PACIFIC/SOUTHERN PACIFIC MERGER: WHAT CAN BE LEARNED?

The Union Pacific/Southern Pacific (UP/SP) merger presented regulators with a classic choice of potential harm to competition supposedly outweighed by enormous efficiencies and improvements in service. The parties proposed to mitigate antitrust concerns through trackage rights and offered substantial cost savings. Instead, the merger was followed by ineffective competition and severe service disruptions. More than two years after consummation of the merger, service quality still has not returned to pre-merger levels. Because the outcome of the UP/SP merger has fallen so far short of expectations, it is important to review what happened to determine the lessons it holds for railroads and their regulators.

The Department of Justice and others asked the Surface Transportation Board (STB) to block the UP/SP merger on the grounds that it would have serious anticompetitive effects. Concerns centered in two areas: rail traffic between California and the eastern United States, and traffic to and from the Texas Gulf Coast. The STB approved the UP/SP merger, reasoning that UP had developed a proposal for addressing what it contended were the only significant competitive problems involved in the merger. This proposal primarily involved trackage rights that would allow the Burlington Northern Santa Fe (BNSF) to operate trains and serve certain shippers on UP lines. Merger opponents objected to this proposal because it did not address all the competitive problems that they saw in the merger. Merger opponents also objected that BNSF could not compete effectively because it would have to use UP's lines. The STB, which had relied on trackage rights to maintain competition in several previous mergers, dismissed these concerns.

The STB also believed that the merger would lead to enormous efficiencies, including $627.4 million annually in quantifiable benefits and many unquantified benefits. The unquantified benefits consisted mainly of improvements in service. The STB confidently predicted that after the merger "UP/SP customers will benefit from tremendous service improvements...." In fact, service on the UP/SP system deteriorated severely after the merger. Shippers complained of long waits for equipment and severe transport delays. Some shippers alleged that plants were forced to curtail production or shut down because of problems with their rail service. In addition, the Department of Transportation raised serious safety concerns concerning the operations of UP/SP.

In October 1997, in response to a request from several shippers' groups, the STB found that a service emergency existed and issued an emergency service order. When the STB then allowed the order to lapse in August 1998, it admitted that rail service was "not at uniformly improved levels." The STB promised to continue to monitor operations of UP/SP and BNSF. Despite recent improvements, shippers complain that service remains far below pre-merger levels.

The experience with this merger holds some important lessons, but caution should be used in drawing them. In particular, it would be too easy to assume that UP's poor performance supports the critics' forecast that the merger would reduce competition, leading to reduced service and higher prices. By definition, an exercise of market power is profitable, but UP did not profit from the service crisis. The decline in UP's service was so severe that it is unlikely to have been deliberately planned by a profit-maximizing firm. Instead, it seems that after the sudden large extension of its network, UP was unable to provide the level of service that it wanted to provide.

While it would be premature to claim that the decline in service shows an increase in market power, it would also be premature to accept UP's claim that the absence of increases in price shows no anticompetitive effects. The decline in UP's performance depressed demand for transportation on its lines and increased regulatory scrutiny. In those circumstances, even a firm that had increased its market power would be unlikely to raise prices.

The merger's aftermath raises troubling questions about the use of trackage rights to address competitive problems. Because BNSF must use UP's lines and rely on UP's switching and dispatching, it has fallen victim to UP's service problems. Any future use of trackage rights to address competitive problems should carefully consider the experience of the UP/SP merger.

Perhaps the most important lesson of the UP/SP experience is that both the STB and railroad management should be skeptical of efficiency claims in mergers. Railroad mergers may have significant benefits, but combining two large railroads is difficult and costly, and those costs should be considered when estimating the net benefits of a merger. In particular, there is a serious danger of creating an organization that is too large and unwieldy to manage. The ultimate lesson of the UP/SP merger is that in railroads bigger may not be better; it may be much worse.

EI Senior Economist Henry McFarland testified against the UP/SP merger in the original STB proceeding. A longer version of this article will appear in Transportation Antitrust Update.

ECONOMIC ANALYSIS OF FCC OWNERSHIP RULES

Competition and diversity are offered as the two bases for the Federal Communication Commission's (FCC) local broadcast station ownership rules. It is instructive to contrast the two. Economic theory shows that markets may provide too little competition and that regulating ownership can preserve competition. No corresponding support exists for an argument that there is too little diversity, nor is there a reliable theoretical link between ownership and diversity. The FCC's "TV duopoly" and TV-radio cross-ownership rules are not needed for either objective.

A general presumption exists among economists, and in society as a whole, that the self-interested actions of individuals and firms in a free market will lead to socially desirable outcomes. There are, however, a few recognized exceptions to this presumption. Economic theory teaches that competing firms have an incentive to combine together, thereby reducing competition and raising their profits at the expense of consumers. The antitrust laws, which are justified by the potential for market failure, are designed to prevent such concentration from occurring.

The antitrust agencies have developed regular, widely-accepted procedures for determining whether or not a particular merger or joint ownership is likely to reduce competition significantly. As a rule of thumb, five or six equal-sized firms, or a larger number of unequal-sized firms, is considered sufficient to safeguard competition. The agencies do not attempt to "maximize" the number of competitors, since mergers and joint ownership can yield benefits to consumers in the form of improved product offerings and lower costs.

Though competition analysis is best done on a case-by-case basis, some general conclusions can be drawn. Currently, the "TV duopoly" rule prohibits a single party from owning more than one TV station within a single local broadcast area. If this rule were relaxed, some consolidations would likely be allowed by the antitrust agencies, while others would likely be opposed. Assuming that TV stations do not compete significantly with other media and so form a separate market, there are many areas of the country in which little or no joint ownership of TV stations could be permitted without significantly reducing competition. About 90 Designated Market Areas (DMAs) have 4 or fewer commercial TV stations. If the DMA is the relevant geographic area in which to analyze competition, moving from 4 to 3 or from 3 to 2 independent owners of healthy competitive stations may reduce competition. By the same token, in many DMAs, joint ownership of TV stations would presumably have no significant effect on competition. In markets with 8 or more commercial stations, of which there are over 40, some joint ownership could probably be permitted without raising competitive concerns.

To take another case, suppose that TV stations and radio stations are considered to be in the same market. In

SELECTED EI CASES IN 1998

Pharmaceuticals Collusion Litigation: Principal Philip B. Nelson led a team of EI economists in support of two of the defendants, Ciba-Geigy and Sandoz (now merged to become Novartis), in this suit alleging collusion by pharmaceutical manufacturers to prevent discounting to retail pharmacies. The court ruled in favor of the defendants who were represented by Dewey Ballantine.

AOL Monopolization Litigation: Working with Crowell & Moring, President Bruce M. Owen and Principal Peter R. Greenhalgh analyzed liability and damages claims for the defendants in a case involving allegations of monopolization by AOL. The parties reached a settlement prior to trial.

Baby Food Price Fixing Litigation: Principal William C. Myslinski testified for the defendant baby food manufacturers regarding allegations that they exchanged information on future price increases. The court granted summary judgment for the defendants who were represented by Dechert, Price & Rhoads, Howrey & Simon, and Drinker, Biddle & Reath.

Publishing Merger: Pearson plc. acquired certain assets of Simon & Schuster in a $4.6 billion acquisition analyzed by Principal William P. Hall. DOJ cleared the merger after Pearson, who was represented by Morgan, Lewis & Bockius LLP, consented to divesting some elementary and college textbooks.

Wire Rod Dumping: Vice President Robert D. Stoner testified on behalf of U.S. producers of steel wire rod in an anti-dumping matter before the International Trade Commission. Petitioners, who were represented by Wiley, Rein & Fielding, argued that the domestic industry was injured by subsidized and dumped steel wire rod. The decision against the petitioners is being appealed.

Halliburton/Dresser Merger: Principal William C. Myslinski and Senior Economist Henry B. McFarland, working with Vinson & Elkins, analyzed issues of market definition, entry, unilateral and coordinated effects, and efficiencies in this merger of oil field services companies. The parties consented to divestitures involving a minimal portion of the combined businesses after DOJ's wide-ranging investigation.

this case, there could be some competitive rationale for limiting cross-ownership of TV stations and radio stations, but there is no justification for an arbitrary cap on the number of cross-owned stations. Permitting TV stations to be jointly owned with radio station groups as large as are permitted by the 1996 Telecommunications Act would actually result in few, if any, markets with high levels of concentration in the largest 50 DMAs, even if the mergers were constructed to maximize concentration.

A case-by-case analysis could show that joint ownership should be permitted in some instances even if the concentration level on its face would indicate a possible competitive problem. For instance, if a station is dark or for some reason does not contribute significantly to competition, joint ownership is probably not anticompetitive. Joint ownership or operation can also enable stations to offer superior services that would not be economical for either station to offer by itself. Such gains may outweigh competitive concerns.

Competition policy is justified by a clearly identified market failure. In contrast, it has not been shown that there is a corresponding market failure that leads to the wrong level of diversity. Unlike the link between ownership and competition, no sound theoretical basis exists for linking deconcentrated station ownership to diversity. Profit-maximizing station owners do not typically enforce their viewpoint on their stations; instead, they provide the diversity that their audiences demand.

Even if ownership rules could reliably be used to increase diversity, it would be a mistake to take an "absolutist" approach to diversity. Following that approach, if diversity is good, then any policy that leads to more diversity must be preferred to any policy that yields less diversity. Such an approach is not the basis for sound decision-making.

In conclusion, competition in broadcasting can be preserved using antitrust standards without the need for one-size-fits-all restrictions like the FCC ownership rules. If, in selected markets, ownership concentration were allowed to rise to levels still consistent with competition standards, there is no reason to think that the associated amount of diversity provided by broadcast stations and other sources would be insufficient. No separate ownership standard based on diversity is warranted.

This article is based on testimony Vice President Kent W Mikkelsen recently provided before the FCC as part of an en banc panel of experts on media ownership regulations.