

PUBLIC UTILITIES

The Bathwater and the Baby: What the Supreme Court thinks about handicapping the incumbent to level the field for new players.

By [Anne S. Babineau](#), William E. Taylor, and [Matthew M. Weissman](#)

Regulators today sit on the horns of a dilemma: How far to level the field in the name of competition?

If regulators fear market power in the incumbent utility, and so impose restrictions on its activities and assets, they may impair its effectiveness and thus distort the very competition they attempt to foster.

One example — restricting utility affiliates in using the parent company's name and logo — was the focus of a recent work in this publication. That article showed how restrictions raise a constitutional question regarding freedom of speech, as defined by decisions of the U.S. Supreme Court. Here, we trek further down that road, examining the Court's Jan. 25 opinion in *AT&T Corp. v. Iowa Utilities Board*.² In light of that case, and the response of the Federal Communications Commission, we review the legal and policy considerations that should guide regulators as they devise restrictions or impose requirements on incumbent utilities to level the field to encourage competition.

Do regulators have the authority to handicap incumbents? The boundaries of such administrative authority are only now being considered. Before continuing, let's look at some past examples.

Consider the AT&T consent decree issued in 1982, which split the telephone industry vertically and prohibited incumbent Bell operating companies (BOCs) from entering long-distance markets. That order was born of the need to fashion remedies for alleged antitrust violations.³

Outside the antitrust context, open-access and other restructuring initiatives in telecommunications and electricity have tradeoffs: a restriction imposed (or sometimes accepted voluntarily) in exchange for certain recognized benefits. For example, Section 271 of the Telecommunications Act of 1996 permits BOCs to obtain access to the long distance market on the condition that they make their networks available to competitors. On the energy side, the Federal Energy Regulatory Commission and many state legislatures and commissions have required open access to the incumbent's transmission and distribution (T&D) networks, at the same time at the same time allowing electric utilities an opportunity to recover their stranded costs. How far down this path can regulators go?

As the cases will show, any administrative authority to impose restrictions on future conduct implies the power to withhold fundamental economic rights from market participants or to decide which rights are essential and which are gratuitous. Such decisions cannot be made in a vacuum, but must follow from a clearly articulated judicial or legislative state or federal policy.

This article focuses on certain proposed restrictions and requirements that federal and state agencies are implementing or considering as a way to promote competition. We show how the Supreme Court's *Iowa* ruling may affect such regulations. We also demonstrate how the ruling may sway regulators to rethink any conditions imposed on the incumbent, especially those requirements that would protect market entrants at the expense of incumbent providers who seek to compete as well.

The Iowa Case: A Model for Open Access

The Telecommunications Act of 1996 fundamentally altered the approach that regulators must take in fostering local exchange competition. Among other things, the Act compels the incumbent local exchange carriers (ILECs) to make proprietary elements of their networks available to competitors, but only where such access is "necessary" and the

failure to provide it would "impair" a new entrant seeking to provide service.

The FCC was given the task of determining precisely what network elements the ILECs should make available-- *i.e.*, decided how to apply the "necessary" and "impair" standards. Initially, the FCC set a low threshold. It explained that the "necessary" standard could be met even where the requested element could be obtained from an alternative source. Competitors could meet the "impair" standard where the incumbent's failure to provide access would even marginally decrease the quality or increase the cost of the service the entrant seeks to offer.⁴

In *Iowa*, the Supreme Court criticized the FCC's take on the issue as too lenient to new entrants. It said the FCC's interpretation probably would allow a competitor to gain access to any network element it wanted, since no new entrant likely would request any inconsequential element. In other words, no entrant likely would ever request access to a network element, which if missing, would not "impair" the entrant's ability to compete in the FCC's weak sense of the word.⁵ The Supreme Court thus vacated the FCC's Rule 319, which had identified seven network elements that were required to be made available to new entrants. Instead, it directed the commission to reevaluate the standard it uses to determine which network elements incumbent local phone companies must unbundle.

How should we view the Supreme Court's opinion?

On one level, the decision makes a straightforward statutory interpretation. The Court saw the FCC's interpretation as inconsistent with the ordinary and fair meaning of the terms "necessary" and "impair."⁶ However, in language that provides some guidance for regulators, the Court went on to suggest an approach for limiting network element availability in accordance with the act.

As the Court majority noted, the appellants had suggested that the act's "necessary" and "impair" language codified "something akin" to the "essential facilities" doctrine of antitrust theory: the opening up of only those "bottleneck" elements unavailable elsewhere in the marketplace. And though the Court stopped short of formally adopting that doctrine, it agreed that the FCC must employ "some limiting standard, rationally related to the goals of the Act."⁷

In his concurring opinion, Justice Breyer also cited the essential facilities doctrine. He suggested that "given the Act's basic purpose," network elements should not be unbundled without "a convincing explanation of why facilities should be shared... where a new entrant could compete effectively without the facility or where practical alternatives to that facility are available."⁸

Intertwined with the Court's statutory analysis are deeper concerns that the FCC's overly "open" view of networks could distort markets. In the Court's view, the FCC rules could have led to (1) excessive and unjustifiable regulatory costs; (2) disincentives for ILECs to invest in and improve their networks and , paradoxically (3) less, rather than more, competition.

The FCC view had implied that "the more the incumbent unbundles, the better." Yet Justice Breyer pointed out in his concurring opinion that "meaningful competition" actually takes place "in the unshared, not... the shared portions of the enterprise..." In a totally unbundled world," said Breyer, "competitors would have little, if anything, to compete about."⁹

Energy Rulings: More Calls for Restraint

In the energy sector, the arguments raised in several recent successful appeals of state PUC decisions suggest further reasons to exercise restraint when requiring incumbent utilities to make network systems available to new competitors.

For example, the New Mexico Supreme Court cautioned against gratuitous public policy findings in vacating a state

PUC order that had required electric utilities to provide transmission, distribution, and related services to a retail competitor without the state's having first set up a statutory framework for electric competition.

It rejected the PUC's argument that its broad authority to set rates or grant certificates of public convenience justified an open-access mandate:

"The NMPUC makes sweeping pronouncements such as: 'It is the better public policy to always subject utilities to the checks and balances of competition,' and 'the public interest is not served by a policy framework that steadfastly holds to a now defunct scheme.' These pronouncements make clear that the purpose of the [NMPUC's] Order is to carry out broad changes in public policy under the 'just and reasonable' standard."¹⁰

This imposing of limits on the PUC's freewheeling pursuit of competition appears consistent with *Iowa*.¹¹

Similarly, the 8th Circuit in *Northern States Power Co. v. FERC*¹² has recognized limits on a federal regulators ability to control terms and conditions of access to the incumbents transmission system, where the regulator attempted to extend interstate rights to the nonjurisdictional retail market in native load. In that case the utility had argued that if it was required to provide comparable transmission to its retail and wholesale customers, its native/retail customers would face power outages, contrary to NSP's obligations under binding state tariffs.¹³ In striking down FERC's requirement as an extra-jurisdictional attempt to regulate curtailments of electrical power to NSP's native/retail customers, the court noted that while wholesale customers enjoyed access to competitive supply alternatives, native load retail customers do not.¹⁴

The *NSP* case thus suggests that regulators should limit their pro-competitive intentions where the incumbent's transmission network is not strictly "necessary" to the continued functioning of the wholesale market, even if alternative supplies or self-generation by wholesalers may be more costly than use of the incumbent's network.

Antitrust Law: Essential Facilities in Network Industries

From an economic perspective, the justification for requiring access is the expectation that forcing open the incumbent's network will accelerate competition sufficiently to outweigh the adverse consequences of meddling in markets. Economists expect such trade-offs to be in the public interest when the network elements in question are essential or necessary for entrants to be able to compete in the retail market.

Fundamentally, this "essential facilities" doctrine represents a trade-off between the possibility of retail gains and wholesale losses. It pits potential welfare gains in the retail market (gains that would be lost if the incumbent were not required to supply the facility to competitors) against potential welfare losses in the wholesale market (losses from the incumbent's diminished incentives to supply essential elements and the competitors' diminished incentives to compete in supplying the elements).

In unregulated markets, antitrust law provides the only basis for requiring a privately owned facility to be shared with competitors. As fragile property rights are involved, the essential facilities test defines narrow and strict criteria: If rivals may compete, in any manner in the same market, without access to the facility, then the facility is deemed non-essential. In general, essentiality requires that the economic importance of the facility to the competitive process be relatively high:

"There is no general duty to share. Compulsory access, if it exists at all, is and should be very exceptional... No one should be forced to deal [*i.e.*, share] unless doing so is likely to substantially improve competition in the marketplace."¹⁵

With an appropriately high threshold for compelling access, damages to incentives will be offset by the benefits to competition in the given market.

While the *Iowa* decision found the economic reasoning restricting mandatory access to some kind of essential facility to be attractive, this doctrine has some wrinkles when applied to regulated network industries such as energy distribution and telecommunications.

First, in formerly regulated public utility markets, property rights are somewhat more controversial than in unregulated markets. The question here is, should the utility be permitted to benefit competitively from advantages that were acquired as a consequence of franchise monopoly and, arguably, not through any innovation, risk-taking or superior effort by the utility? Because these advantages were developed under a regulated franchise, some parties argue that they should not belong exclusively to the utility-- as opposed to the competing retail entity-- and that public interest considerations and not stricter property right-concerns should govern the policy determining sharing of essential facilities with competitors.¹⁶ Note that if this argument is persuasive, it still only applies to facilities or services rooted in the public utility past. In telecommunications, for example, this argument cannot be used to require mandatory unbundling of elements of new broadband data networks. Undue breadth in the definition of what constitutes "advantages acquired as a consequence of the franchise monopoly" will undermine the initiative of the incumbent, weakening its participation as a competitor on the new playing field.

Justifying Open Access: What Rights Must Incumbents Share?

The task for regulators today calls for distinguishing normal and appropriate competitive advantages from that which is unfair.

What factors will agencies consider in determining whether to restrict or prohibit the incumbent from sharing facilities, services, employees and corporate support services between its regulated and competitive operations? How will they decide whether to open up to competitors the same access facilities, services, employees or support used for regulated activities?

Iowa suggests that where certain components essential for competitive services and controlled by the incumbent are used by the regulated and competitive sides of incumbent's business, the incumbent should not be the only one to gain access to such services for its own use or that of its affiliates, to the detriment of its competitors who cannot obtain such access to such rights. In these circumstances, the incumbent should be compelled to make available to itself or its competitive affiliates, and on the same terms and conditions. Otherwise, regulators might consider prohibiting joint use of those facilities by utilities and their competitive affiliates.

Also, *Iowa* teaches a reasoned approach: The justifiable restrictions are those that do not unnecessarily add "significant administrative and social costs inconsistent with" the purposes of the governing legislation. These acceptable restrictions will not diminish the incumbent's incentive to keep up or to improve the property by depriving it of the benefits of its "value-creating investment, research or labor."¹⁷

These issues can arise in the context of asset divestiture or codes of conduct.

For example, there are vocal constituencies that seek to mandate that the incumbent provider of regulated energy or telecommunications service must divest itself of all competitive functions plus the facilities, support services and personnel related thereto. This structural separation or divestiture would leave the incumbent utility with the obligation to serve but with none of the economies of scale it previously enjoyed. To the extent that such recommendations result in more restrictions than are absolutely necessary, or to the extent that they result in excessive costs, *Iowa* would suggest that they cannot be sustained.

In addition, some state commissions have recognized that compelling structural separation or divestiture can impose direct monetary costs, and result in loss of efficiencies and economies of scope. For example, in New Jersey the Board of Public Utilities rejected structural separation as the only way to guard against cross-subsidization, relying instead on a cost allocation system reviewed and approved by the Board and found to be an adequate safeguard for competition.¹⁸ A counterexample is Pennsylvania, where as part of its Aug. 26 decision, the commission ordered Bell Atlantic to market its wholesale and retail services through separate subsidiaries.¹⁹

Similarly, standards or codes of conduct are designed to prevent discrimination or preferential treatment that might favor the incumbent's affiliate in offering competitive products. The standards are based in large part on the assumption that the utility has access to certain information, services, facilities and unused capacity and supply and, as a result, can enhance its competitive position or that of its affiliate, at the expense of competitors.

While some might favor a prohibition against any sharing of information, services, facilities or capacity between the competitive entity and the entity providing traditional electric and/or gas public utility merchant functions, a complete bar might cause unnecessary duplication of expenses. This would result, as the Court warned in *Iowa*, in "significant administrative and social costs" that may "make the game not worth the candle."²⁰

Cross Subsidies: Restricting the Incumbent in Pricing Decisions

While most may agree that the incumbent should not use regulated services to cross-subsidize competitive offerings, pricing restrictions still spark controversy. Here *Iowa* would suggest that regulators keep the goal in mind—to encourage competition, not to protect competitors.

For example, certain affiliate relations standards for energy utilities require that pricing of retail competitive products or services equal or exceed some fully allocated cost to the incumbent to provide the product or service.²¹ Such a rule would unduly impede the ability of the incumbent to compete and thereby lessen the vitality of the competition that the regulator is attempting to encourage.

It is not necessary to price a product to cover fully allocated costs in order to avoid cross-subsidization. Sound economic principles indicate that cross-subsidization will only result if an entity fails to cover its incremental, not its fully allocated costs.²² Ironically, imposition of a fully distributed cost-based retail price floor would encourage competitors but deny customers the principal benefit for that competition (*i.e.*, lower prices).

Epilogue: Did the FCC Learn Its Lesson?

On Sept. 15, the FCC adopted new rules on what network elements incumbents must make available to new entrants. Some of these new rules suggest that the agency has heard the Supreme Court's message in *Iowa*.

The FCC's new rules eliminate operator and directory assistance services from its pre-*Iowa* list of seven elements that must be made available, since competitors can and do provide such services for themselves and/or can acquire them from alternative sources.²³ In addition, except in limited circumstances, the FCC refused to add an obligation to provide high-speed Internet access and other data services (packet switches and digital subscriber line access multiplexers) to the required list of facilities required to be unbundled. On this issue, the FCC described its rationale as follows:

"Given the nascent nature of this market and the desire of the Commission to do nothing to discourage the rapid deployment of advanced services, the Commission declined to impose an obligation on incumbents to provide unbundled access to packet switching or DSLAMs at this time... [C]ompeting carriers are aggressively deployment such equipment in order to serve this emerging market sector."²⁴

Nevertheless, the FCC's extensive of obligations on incumbents to provide access to certain additional elements not on the original list of seven (*e.g.*, subparts of loops and dark fiber) certainly indicates that it is not reluctant to impose new obligations on the incumbent, notwithstanding *Iowa*. Moreover, the FCC's unwillingness to eliminate switching from the list of requirements seems to us inconsistent with the *Iowa* decision, absent evidence that new entrants would be materially impaired without such access. The FCC recognized that new entrants are now providing switched-based alternative service in major metropolitan areas and, at least as the partial dissent of Commissioner Michael K. Powell notes, new entrants potentially can serve many other consumers even beyond those areas.

It is clear, however, that the FCC's consideration of such requirements is far from over. The FCC has acknowledged an obligation to revisit the unbundling requirements in light of the fact that "rapid changes in technology, competition, and the economic conditions of the telecommunications market will require a reevaluation of the national unbundling rules periodically."²⁵ The obligation to reconsider such requirements, over time, suggest that the list will get shorter, not longer, in the future.

Endnotes

1 "Utility Affiliates: Why Restrict Use of Names and Logos?" Charles J. Ogletree Jr., Karen Miller and Ronald C. Jessamy, *Public Utilities Fortnightly*, July 15, 1999, p. 34. The authors there urged caution by regulators: "...even as states open the way for competitors, certain vocal constituencies would handicap utilities and their affiliates, denying them equal footing. New entrants seek to eliminate or constrain competitive advantages they would ascribe to utility affiliates. In fact, some state public utility commissions (PUCs) have embraced this idea of competitive handicapping.... [T]hose advocating this sort of competitive handicapping seek to achieve through PUC rules what the U.S. Supreme Court consistently has declined to permit under the antitrust law: protecting competitors rather than protecting competition." *Id.* at 34-35 (emphasis added).

2 525 US 366, 119 S. Ct. 721, 142 L.Ed.2d 835 (1999).

3 *United States v. American Tel. & Tel. Co.*, 552 F. Supp. 131, 186-88 (D.D.C. 1982). Local exchange markets were thought to be natural monopolies in 1982, and the lines of business restrictions on the Bell Operating Companies were invoked to prevent anticompetitive leveraging of local exchange market power into long distance, information services and customer equipment markets.

4 *AT&T Corp. v. Iowa Utilities Board*, 119 S. Ct. at 734-36, 739.

5 *Id.*, at 735.

6 The Court concluded that in granting new entrants access to network elements, the FCC could not entirely disregard the availability of elements from sources outside the incumbent's network, nor could it treat any increased cost or decreased service quality whatsoever flowing from the incumbent's failure to provide a particular element as establishing a "necessary" and an "impairment" of the entrant's ability to provide services.

7 *Iowa*, 119 S.Ct. at 734-35

8 *Id.* 119 S. Ct. at 735 (Breyer, J., concurring in part and dissenting in part).

9 *Id.* 119 S. Ct. at 753-54 (Breyer, J., concurring in part and dissenting in part).

10 *New Mexico v. N.M. PUC*, 980 P.2d 55,62 (N.M. 1999).

11 Note also that in an appeal to the Michigan Supreme Court, the incumbent electric utilities successfully contended that the state commission went too far in ordering the utilities to implement an experimental retail wheeling program. The State Court of Appeals had affirmed the commission's order, based on the commission's broad statutory authority to, *inter alia*, "control and supervis[e]...the business of transmitting and supplying electricity." *Consumers Power Co. v. Mich. PSC*, 227 Mich. App. 442, 451-52 (1998). In a 4-3 decision, the state Supreme Court reversed, ruling that the commission lacked statutory authority to order a utility to transmit a third-party provider's electricity through its system to a utility customer, and that the commission had exceeded its authority in ordering utilities to engage in specific management practices or to enter into certain contracts. *Consumers Power Co. vs. Michigan PSC*, Nos. 111482-3, et al., slip op. (Michigan Sup.Ct. June 29,1999).

12 176 F.3d 1090 (8th Cir. 1999)

13 *Northern States Power*, 176 F.3d at 1095

14 *Id.*

15 Areeda, Phillip, "Essential Facilities: An Epithet In Need Of Limiting Principles," 58 *Antitrust Law Journal* 1990,

pp. 841-853.

16 The determination of whether a facility is essential in a particular market ought to take the likely regulated price that the facility into account.

17 Iowa, 119 S. Ct. at 753 (Breyer, J., concurring in part and dissenting in part).

18 Application of Bell Atlantic-New Jersey, Inc. for Approval of an Extension of its Plan for an Alternative Form of Regulation, 291 N.J. Super. 77 (App. Div. 1996).

19 Joint Petition of Nextlink Pennsylvania, Inc., Pa. P.U.C., Dkt. Nos. p-00991648, P-00991649, Aug 26, 1999 (Order entered Sept. 30, 1999).

20 Iowa, 119 S. Ct. at 754 (Breyer, J., concurring in part and dissenting in part).

21 See Mass Regs. Code tit.202, section 12.04(2) (1998) (a natural gas or electric distribution company may provide certain assets or services to an affiliate provided that the price charged is equal to or greater than the distribution company's fully allocated costs to provided such asset or service).

22 For example, in a 1999 Resolution of NARUC's Electricity Committee regarding cost-allocation guidelines for the energy industry, the committee recognized that while "generally, the price for services, products and the use of assets provided by regulated entity to its non-regulated affiliates should be at the higher of fully allocated costs or prevailing market prices," such prices "could be based on incremental cost, or other pricing mechanisms" under "appropriate circumstances" as determined by regulators. See www.naruc.org/Resolutions/summer99.htm.

23 The FCC's decision in CC Docket No. 96-98 was announced in a press release dated Sept. 15 (FCC Press Release). The reasoning that supports this decision is not yet known as the decision itself has not been released.

24 See FCC Press Release.

25 FCC Press Release.

Attorneys Anne S. Babineau and Matthew M. Weissman of the law firm Wilentz, Goldman & Spitzer, headquartered in Woodbridge, NJ, represent clients in the telecommunications and energy fields. William E. Taylor Heads the Cambridge, Mass., office of National Economic Research Associates Inc. (NERA), where he is director of the telecommunications practice. NERA provides expert economic analysis on many telecommunications and energy issues nationwide and throughout the world.

[Back to Publications](#)

[Home](#) | [What's New](#) | [Corporate Services](#) | [Individual Services](#) | [Attorney Biographies](#) | [Publications](#)
[Employment Opportunities](#) | [Directions](#) | [Search](#) | [Guest Book](#) | [Disclaimer](#)

Send e-mail to webmaster@wilentz.com with questions or comments about this web site.
Copyright © 1998-99 Wilentz, Goldman, & Spitzer, P.C., All rights reserved.