No Anticompetitive Conduct, No Unearned Advantage: Effective Competition Depends on Merit

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For 40 years, regulation has struggled with this question: *How do we bring effective competition to industries dominated for decades by government-protected monopolies?* The struggle persists, because no one loses his monopoly lightly: not only in the traditional sectors—telephone service; natural gas transportation; and electricity generation, transmission, and retail services;— but in new areas like internet content and delivery, distribution-level electricity resources, and electric vehicle charging stations. We want competition to produce diversity, yet the major players remain the same. One reason: We address only anticompetitive conduct while ignoring unearned advantage. The competition that results is not competition on the merits.

"Effective" competition: The adjective "effective" forces factual analysis into a topic too often discussed rhetorically. Effective competition is not mere rivalry. It is competition on the merits, competition won through performance.

Scherer and Ross describe effective competition in terms of market structure and seller conduct. They identify three structural characteristics: (a) The number of sellers is "at least as large scale economies permit"; (b) there are no "artificial inhibitions on mobility and entry"; and (c) the products offered have "moderate and price-sensitive quality differentials." Within that market structure, the conduct among competitors should have these six characteristics: (a) Competitors have "some uncertainty. . . as to whether one rival's price moves will be followed by the others"; (b) the competitors are not colluding; (c) there are no "unfair, exclusionary, predatory, or coercive tactics"; (d) inefficient suppliers are not somehow protected from competition; (e) "sales promotion should be informative, or at least not be misleading"; and (f) there is no "no persistent, harmful price discrimination."[1]

An effectively competitive market structure produces pro-competitive conduct, which in turn produces pro-consumer performance. Consumers shop based on merits, sellers strive to succeed on the merits, costs decline, quality improves, breakthroughs happen. Structure forces conduct, conduct produces performance.

For industries historically dominated by government-protected monopolies, effective competition is achievable only if we remove both their market power and their unearned advantages, discussed next.

Market power and anticompetitive conduct: A market is not effectively competitive if any seller has "market power": the "ability profitably to maintain prices above competitive levels for a significant period of time."[2] Excessive price is not the only harm; market power can also cause reduced output, inefficient operations, declines in quality, and dulled incentives for innovation.

With market power, a seller can engage in anticompetitive conduct. Four major forms of anticompetitive conduct are: (a) *refusing to deal* (such as refusing to sell competitors a monopoly product essential for competition and not economically duplicable); (b) *tying* (requiring buyers of a monopoly product to also buy the seller's competitive product); (c) *price squeeze* (raising the price of an essential upstream product so that the buyer cannot compete successfully with the seller in the downstream market); and (d) *predatory pricing* (charging prices "below an appropriate measure of cost for the purpose of eliminating competitors in the short run and reducing competition in the long run").[3]

How does anticompetitive conduct differ from aggressive, pro-competitive conduct? The answer is not that someone wins and someone loses; win-loss outcomes are inherent in any competition. Anticompetitive conduct weakens competitive forces, so that the losers lose for reasons unrelated to their merits. Effective competition is competition on the merits; anticompetitive behavior seeks to prevent competition on the merits.

Unearned advantage: In the context of utility regulation, unearned advantage is government-assisted advantage: the advantages accrued from decades of government protection from competition, plus decades of government price-setting calculated to produce reasonable returns. When the utility (or its affiliate or successor) enters a competition, these advantages act as entry barriers—differences in market entry cost between the incumbent and a new entrant. These advantages come in two categories.

The first category concerns *customer behavior*. The utility's name recognition and its government imprimatur create brand loyalty. Brand loyalty combines with normal human inertia to increase the likelihood that a busy customer will choose the utility (or its affiliate) over a newcomer—unless the new entrant spends a lot of money to change the customer’s mind.

The second category concerns the utility's internal characteristics, four in particular: its (a) in-house knowledge, financed by decades of captive ratepayer payments; (b) economies of scale, derived from monopoly service territory boundaries drawn by state law; (c) low-cost access to capital markets, attributable in part to the government’s continuing role of limiting competition and setting reasonable rates; and (d) surplus capacity (a utility must build capacity in "lumps," ahead of demand, to be ready always to meet that demand). Those internal characteristics help the utility (or its affiliate) price below its competitors. And because these advantages flow from government conduct rather than performance merits, their presence precludes competition on the merits.

I have focused on government-sourced advantage because not every unearned advantage warrants regulatory concern. Unearned advantage is inherent in human society. People born to wealthy families, people of races or ethnicities not subject to systemic discrimination, people born with gratification-deferral wiring, hockey players born early in the year, children whose middle school had an unused computer[4]—all have life-long advantages not attributable to their personal merits. It is impossible to have markets in which no company has an unearned advantage. But regulation can address the unearned advantages created by regulation.

No anticompetitive conduct does not mean no unearned advantage: Anticompetitive conduct is competitor conduct. It is prohibited by antitrust law. Unearned advantage comes from government conduct. Competing with government-assisted advantage does not violate antitrust law. Antitrust law prohibits anticompetitive behavior in a given market; it does not remove government-assisted advantages from that market.

Yet government-assisted advantages enable the utility to beat its competitor for reasons other than merit. Some utilities obscure that fact. Their witnesses argue that if utilities engage in no anticompetitive conduct, they should be allowed to "compete" as they wish. When regulators accept that argument, they misunderstand the term "compete." Effective competition means not merely "competing;" it means competing on the merits. Competition means winners and losers. Winning for reasons other than merit means displacing competitors with more merit. That makes consumers worse off—an outcome precisely opposite to competition's purpose.

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No hardworking white male, with his Harvard Business School degree and his McKinsey job, wants to admit it. No utility affiliate with its dominant market position wants to admit it. But they both got where they are thanks in part to unearned advantage. To ensure effective competition, eliminating anticompetitive conduct is necessary but not sufficient. Advantages created by government can be removed by government. Only by doing so can we have real competition, effective competition, competition on the merits—competition whose purpose is to help the consumer, not entrench the incumbent.

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[1] F.M. Scherer and David Ross, *Industrial Market Structure and Economic Performance* 53-54 (1990). For anyone working in regulated industries, this landmark text is required reading.

[2] U.S. Dep't of Justice & Fed. Trade Comm'n, *Horizontal Merger Guidelines* § 0.1 (1992), rev. 1997). The Guidelines were revised in 2010, but the 2010 version does not expressly define "market power."

[3] *Cargill, Inc. v. Monfort of Colo., Inc.*, 479 U.S. 104, 117-18 n.12 (1986).

[4] The last two items come from Malcom Gladwell, *Outliers: The Story of Success* (2011). A disproportionate fraction of Canadian professional hockey players were born early in the year. At age 4, when league play starts, they were bigger than their peers, and so got more coach-attention. Bill Gates's middle school had a spare computer.