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James I. Serota
Vinson & Elkins L.L.P.

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Monopoly Pricing in a Time of Shortage

*James I. Serota**

I. INTRODUCTION

Traditionally, the electric power industry has been heavily regulated at both the federal and state levels. Recently, the industry has been evolving towards increasing emphasis on market competition and less pervasive regulation. Much of the initial impetus for change has occurred during periods of reduced demand and increased supply. More recently, increases in demand and supply shortages have led to brownouts, rolling blackouts, price spikes and accusations of “price gouging.”¹ The purpose of this paper is to examine the underlying economic and legal bases for regulation and antitrust actions, and the antitrust ground rules for assessing liability for “monopoly pricing in times of shortage.” In this author’s view, price changes in response to demand are the normal reaction of a competitive market, and efforts to limit price changes in the name of “price gouging” represent an effort to return to pervasive regulation of electricity. The antitrust rules of monopolization do not and should not change in response to shortage conditions. To change those rules to respond to price changes that are market driven, not market power driven, defeats the purpose of competition and the antitrust rules that govern it.

II. THE ECONOMICS OF SHORTAGE

The California energy crisis has led economists to different conclusions regarding its root causes. MIT Economists Paul Joskow and Edward Kahn concluded that an inordinate number of plants were taken offline for maintenance in the summer of 2000 when the price

* James I. Serota is a partner in the New York City office of Vinson & Elkins L.L.P. The author gratefully acknowledges the research assistance of Sean Keveney, a summer associate at Vinson & Elkins L.L.P.

1. See, e.g., Andrew Caffrey, *States Try to Deter Power Price Gouging*, WALL ST. J., Apr. 30, 2001, at A2, available at 2001 WL-WSJ 2861910; see also James Sterngold, *5 Power Generators Sued in California*, N.Y. TIMES, May 3, 2001, at A21, available at 2001 WL 20058333.

spikes were at their peak.² They think that this behavior is consistent with the withholding of some capacity to raise the price of electricity produced by other units of the same firm, an indicia of market power.

Harvard's William Hogan and Scott Harvey of LECCG, a consulting firm, "argue that generators in California priced above marginal cost, not because they had market power, but because [of bidding procedures in California's auction market]."³ The independent system operator ("ISO") reserve power auction was conducted after the power-exchange auction.

This sequential feature converted the day-ahead auction from an everyone-gets-the-market-price auction (and thus generators would bid at marginal cost to ensure being selected to produce as long as costs were covered) to a pay-as-you-bid auction in which all participants, if selected, receive what they bid rather than the (potentially) higher market-clearing price.⁴

Ratepayers are not responsive to price signals because these users are not charged real time marginal prices.⁵

Similarly, University of California-Berkeley economist Steven Stoft concluded, "[t]he failure of consumers to respond [because of price controls] is the fundamental flaw that makes prices reach exorbitant levels when there is a little scarcity or when suppliers have even a little market power."⁶ University of Maryland and Resources for the Future economist Tim Brennan also suggested that the California procedures created incentives for high market-clearing prices.⁷

The rules of the auction allowed generators to offer different amounts of electricity at different prices rather than all of their output at one price. Under those rules, generators had the incentive to offer a small amount of their output at very high prices because, if the high bid was accepted, they would receive that price for all their output. And if the bid was not accepted, the generators would lose only the sale of a small fraction of their possible output. Normally such bidding behavior would be unprofitable because the probability of the high bid's being accepted would be small, but, in a very tight supply

2. Jerry Taylor & Peter VanDoren, *California's Electricity Crisis: What's Going On, Who's to Blame, and What to Do*, POL'Y ANALYSIS, July 3, 2001, at 12.

3. *Id.*

4. *Id.*

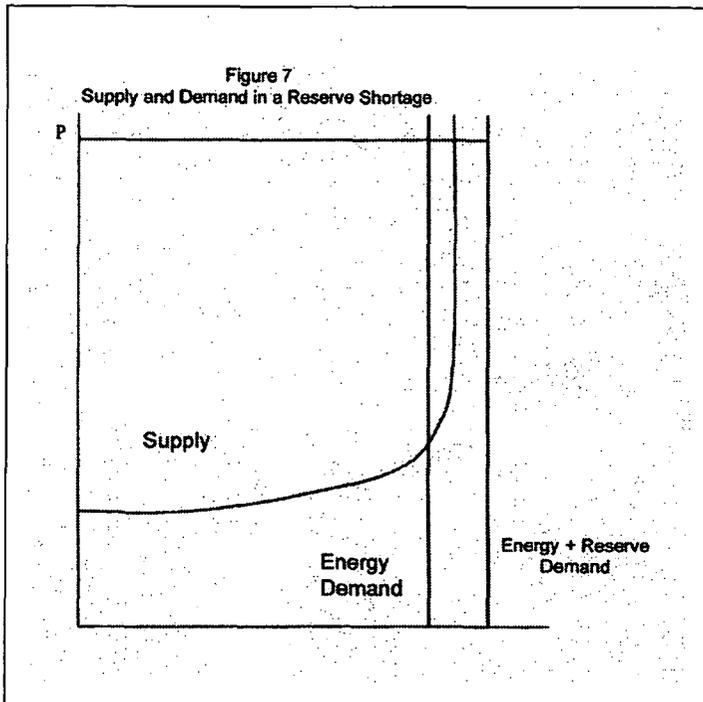
5. The phenomenon is not limited to electricity. Third party payment of healthcare often leads to over-utilization of services. Healthcare economists call this "the moral hazard of insurance." See, e.g., *Med. Arts Pharmacy v. Blue Cross & Blue Shield*, 675 F.2d 502 (2d Cir. 1982).

6. Taylor & VanDoren, *supra* note 2, at 12.

7. *Id.*

situation, the probability of the bid's being accepted rises considerably, and the opportunity cost of the unsold power falls.⁸

Whether these conditions are unique to California or not, it is important to understand the economics of an energy shortage without regard to factors which are *sui generis* to any one particular jurisdiction. LECG's Scott Harvey and Professor William W. Hogan of Harvard accurately describe the typical pricing behavior of a control area, i.e., a market, in shortage.⁹



In a capacity shortage, ancillary service prices will be high, and these high ancillary service prices will be reflected in energy prices. In shortage hours, the price of energy will reflect both incremental generating costs and the capacity price. *Comparisons of the price of energy in shortage situations to incremental generation costs will always therefore find that energy prices appear to be "too high," but this would not reflect the exercise of market power, but only a*

8. *Id.* at 11-12.

9. Scott Harvey & William W. Hogan, Issues in the Analysis of Market Power in California 19 (Oct. 27, 2000), available at http://ksghome.harvard.edu/~WHogan.CBG.Ksg/HHMktPwr_1027.pdf (unpublished manuscript).

mistaken criterion for the competitive level of energy prices. . . . Since all bids would be accepted in some market in a shortage situation, competitive suppliers have an incentive to submit above-cost bids in an expected shortage situation in order to ensure that they are paid the market-clearing price of capacity.¹⁰

The clear message is that in a supply and demand imbalance, the shortage conditions are the price givers, not the market participants. Certain bidding strategies might increase profits for some "inframarginal generators" with favorable long-term contracts. However, while such strategies might increase overall profitability by bidding successively small amounts at a very high price, they are not ordinarily profitable but for a tight supply situation.¹¹ It is the rules and the tight supply situation that together act as the price giver, not the supplier. If the rules permit a generator to bid varying amounts of output at increasing prices until a clearing price is reached, the inframarginal producers do not need to engage in that type of bidding strategy in a shortage in order to increase their overall profitability. A market structure with a diverse mix of suppliers including "peaking plants," marginal producers with small output, is a market circumstance that is sufficient to cause higher prices in a tight supply situation. Such plants are ordinarily designed to operate only in tight supply situations where higher cost production is profitable. This is not an exercise of market power but a reflection of scarcity rents.¹² The important lesson of these market circumstances is that a shortage imbalance in a market structure with a widely diverse mix of suppliers will cause prices to rise appreciably during a shortage. As Professor Hogan has stated, the conclusion "that energy prices appear to be 'too high' . . . reflect[s] [not] the exercise of market power, but only a mistaken criterion for the competitive level of energy prices."¹³

III. THE ECONOMICS OF MONOPOLIZATION

The economics of monopolization are generally considered to be distinct from those of scarcity or shortage. The economics of

10. *Id.* at 19-20 (emphasis added).

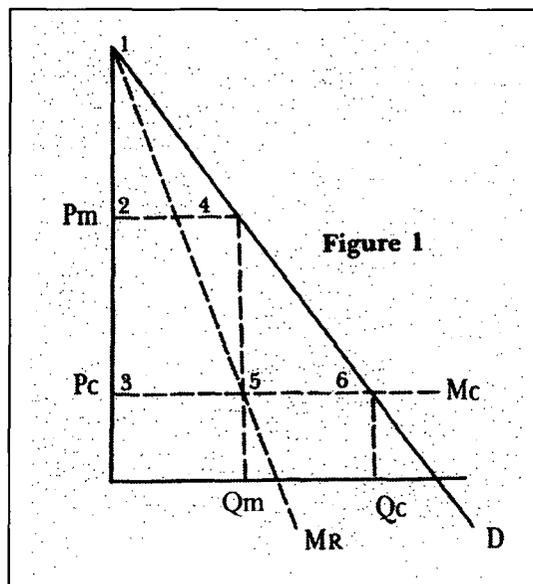
11. Taylor & VanDoren, *supra* note 2, at 12.

12. In a 1983 *Yale Law Journal* article on airline deregulation, the author distinguishes between scarcity rents that pay for the risk of under-utilization in light of high fixed costs and monopoly profit arising from the creation of barriers to entry and reduction of output below full utilization. Stephen E. Creager, *Airline Deregulation and Airport Regulation*, 93 *YALE L.J.* 319 (1983). Higher than "normal" prices in a period of full capacity utilization are consistent with the former, not the latter.

13. Harvey & Hogan, *supra* note 9, at 19.

monopolization are essentially the same as those of price fixing. As Professor Hovenkamp describes in his classic 1989 article:

The simplest overcharge case involves a monopolist or cartel member charging its short-run profit-maximizing price. Figure 1 illustrates. In perfect competition, a firm sets price equal to marginal cost, or P_c , and output is Q_c . However, the monopolist or cartel will reduce output to the point that marginal cost equals marginal revenue, or Q_m , and price will rise to P_m . Rectangle 2-3-5-4 becomes a transfer of wealth from consumers to the monopolist, Triangle 4-5-6 represents the traditional “deadweight loss” from monopoly—that is, resources that are denied to consumers but do not show up as gains to the monopolist either. If the demand curve is linear, triangle 4-5-6 will be exactly half as big as rectangle 2-3-5-4. Assuming the wealth transfer caused by this monopoly is \$100, the deadweight loss will be \$50. If the demand curve is not linear, the deadweight loss triangle can be greater than or less than half the wealth transfer.¹⁴



The chart above describes an industry that is conducive to “supra competitive pricing,” a consequence of the exercise of monopoly. Monopoly power is the “power to control market prices or exclude competition.”¹⁵ As the previous graph shows, reduced capacity causes marginal prices to rise above marginal cost with a wealth transfer to the

14. Herbert Hovenkamp, *Antitrust's Protected Classes*, 44 REC. OF THE ASS'N OF THE BAR OF THE CITY OF NEW YORK 493, 496-97 (1989).

15. *United States v. E. I. du Pont de Nemours & Co.*, 351 U.S. 377, 391 (1956).

monopolist and a deadweight loss to society. The question in a shortage market, therefore, is not whether the seller is exceeding a historical base level of competitive prices, but rather whether the seller has the ability to raise prices unilaterally in the market. Is the putative monopolist a price giver or a price taker, or is the market or some other actor, such as government regulation, dictating the conditions that cause “supra competitive” pricing above marginal cost? In a shortage, unless the shortage is caused by reduced capacity, there is no “deadweight loss” to society.¹⁶ Because the economics and the graph described by Hovenkamp are distinct from that described by Hogan and Harvey, should the case law track the economics, or should the law of monopolization and scarcity merge because both describe a condition of pricing above marginal cost?

IV. WHAT ARE THE ANTITRUST RULES OF MONOPOLIZATION, AND DO THEY CHANGE IN TIMES OF SHORTAGE?

If the issue is what is monopoly pricing in times of shortage, the question to ask is whether this industry is subject to monopolization. The mainstream view of the Sherman Act begins with the *Standard Oil* case.¹⁷ In *Standard Oil Co. v. United States*, the Supreme Court summarized the history of the pre-1890 common law including the English statutory prohibition against monopoly and the effects that flowed from it, i.e., the power to fix prices and injure the public and the power to limit production.¹⁸

The Supreme Court interpreted section 2 of the Sherman Act as a corollary to section 1.¹⁹ As a result, various forms of anticompetitive practices enumerated in section 1 could not be used as a limitation on the mechanism by which monopoly and its evils could be achieved.²⁰ This interpretation of the Sherman Act led the Court to order the dissolution of the Standard Oil Trust and the American Tobacco Trust.²¹

While the words “restraint of trade” and “monopolize” used in Sections 1 and 2 take their initial meaning from pre-1890 common and statutory law, they are redefined to effectuate a statutory policy of protecting the public against wrongs which the Congress thought might flow from situations, popularly called “monopoly,” where

16. Deadweight loss is the social cost of monopoly caused by the reduction in the available good to society separate from the wealth transfer to a monopolist.

17. *Standard Oil Co. v. United States*, 221 U.S. 1 (1911).

18. *Id.* at 51-58.

19. *Id.* at 50-51.

20. *Id.* at 59.

21. *United States v. Am. Tobacco Co.*, 221 U.S. 106 (1911).

competition—by whatever means—was unduly limited. The Standard Oil opinion defines the object of the Sherman Act, as well as the common law, as the prohibition of all “contracts or acts which it was considered had a monopolistic tendency, especially those which were thought to unduly diminish competition,” and of acts “producing or tending to produce the consequences of monopoly.”²²

Whether the focus is on specific acts of conspiracy or deliberate acts that produce monopoly, the basic object of the antitrust laws has been to focus on the ability of a competitor or a group of competitors to dictate price to the market. In the seminal *Alcoa* opinion, Judge Augustus Hand stated:

Starting . . . with the authoritative premise that all contracts fixing prices are unconditionally prohibited, the only possible difference between them and a monopoly is that while a monopoly necessarily involves an equal, or even greater, power to fix prices, its mere existence might be thought not to constitute an exercise of that power. That distinction is nevertheless purely formal; it would be valid only so long as the monopoly remained wholly inert; it would disappear as soon as the monopoly began to operate; for, when it did—that is, as soon as it began to sell at all—it must sell at some price and the only price at which it could sell is a price which it itself fixed.²³

The case law is now clear that under section 2 of the Sherman Act, 15 U.S.C. § 2, liability for monopolization requires the possession of monopoly power in a relevant market and the willful acquisition or maintenance of that power.²⁴

Attempts to redefine the law of monopolization for shortage conditions have generally been unsuccessful. In 1973, Agrico Chemicals refused to supply certain products used in fertilizer production to anyone other than long-term customers.²⁵ The fertilizer maker sued its prior supplier of raw materials for monopolization, contending that by virtue of a shortage, each producer becomes a monopolist of its own source of scarce materials and has a responsibility to supply competitors with adequate amounts of the product effectively.²⁶ The court rejected the “shortage” theory of monopolization, citing an earlier decision by then Judge Stevens of the

22. REPORT OF THE ATT'Y GEN.'S NAT'L COMM. TO STUDY THE ANTITRUST LAWS 11 (Mar. 31, 1955).

23. *United States v. Aluminum Co. of Am.*, 148 F.2d 416, 427-28 (2d Cir. 1945).

24. *United States v. Grinnell Corp.*, 384 U.S. 563 (1966).

25. *Cent. Chem. Corp. v. Agrico Chem. Co.*, 531 F. Supp. 533, 538 (D. Md. 1982).

26. *Id.* at 538-39.

Seventh Circuit in *Mullis v. ARCO Petroleum Corp.*²⁷ In *Mullis*, Judge Stevens rejected the argument that a shortage wherein supplies are hard to obtain causes the overall market to be redefined.²⁸ Furthermore, the court stated that restraints by the government during the shortage do not make a monopolist out of a company with small market share where at least twenty other companies were selling the same generic product, albeit subject to the same government imposed restraints.²⁹ As the court held, such a theory would make monopolists of all other competitors as well.

Similarly, in *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*,³⁰ the Court reviewed the consequences of pricing above marginal costs, i.e., supercompetitive pricing. The Court determined that

[o]nly if those higher prices are a product of nonmarket forces has competition suffered. If prices rise in response to an excess of demand over supply, . . . the market is functioning in a competitive manner. Consumers are not injured from the perspective of the antitrust laws by the price increases; they are in fact causing them.³¹

The lesson of prior energy shortages is that uncoordinated price changes by participants, even with significant shares but less than market power, are not indicia of monopolization. They cannot cause price increases but for excess demand, supply shortages, artificial bidding rules or artificial restraints on the terms of competition. Prior efforts to impose antitrust liability where industry suppliers have substantially less market share than that typically attributed to a monopolist have been unsuccessful.³²

Consider, for example, the consequences of imposing antitrust liability on suppliers who price above an industry average marginal cost. California bidding rules, as previously described, determined that

27. *Id.* at 550-51 (citing *Mullis v. ARCO Petroleum Corp.*, 502 F.2d 290, 297-99 (7th Cir. 1974)).

28. *Mullis*, 502 F.2d at 297.

29. *Id.*

30. *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

31. *Id.* at 232.

32. The late Senator Philip Hart, of Michigan, introduced the Industrial Reorganization Act of 1972, S. 1167, the so-called "shared monopoly act," which imposed antitrust penalties for non-colluding companies with relatively lower market shares than normally found in "monopolized" markets. See also WHITE HOUSE TASK FORCE REPORT ON ANTITRUST POLICY (1969), reprinted in ANTITRUST TRADE REGULATION REPORT, No. 411, Special Supplement Part 11 (1969). With the rejection of the FTC's efforts to prosecute the cereal companies for a "shared oligopoly," in *Kellogg Co.*, [1970-1973 Transfer Binder] Trade Reg. Rep. (CCH) ¶ 19,898 (1972), *initial decision vacated and complaint dismissed with prejudice*, 99 FTC 8 (1982), these theories have had no intellectual support in over 25 years.

each additional supplier bid the expected market clearing price.³³ Higher prices appear at least in part to be a product of these rules, not the exercise of monopoly power condemned by the antitrust laws. Even if those bidding rules were not in place, as Hogan, Harvey, Taylor and VanDoren noted, the price would have risen appreciably above marginal cost for many producers. Most energy markets have a wide range of generators with varying capacities and fuel sources. The smallest are usually peaking plants of 100 megawatts or less, fueled by natural gas. The plant is designed only to provide reserve capacity or ancillary services, and is available to supply energy only at the times of highest demand. Its high cost structure is designed to achieve profitability only when demand is at its highest and prices are substantially above marginal cost for most other producers. It may choose to withhold its capacity during most hours of most days because if it offered its capacity at a price similar to that of a larger “must-run” nuclear plant, it would lose money. In markets such as California where the market capacity is approximately 58,000 megawatts, to impose antitrust monopolization liability for a producer of 2/10 of one percent because at certain peak times, it and similarly situated plants may be the only capacity available, strains the common meaning of “price giver.” Yet, because of certain government regulations including bidding procedures, sales by such plants and sales by traders without any physical capacity at prices above historical levels or those of larger more efficient competitors provoke cries of price gouging. As stated in *Brooke Group* as well as in *Central Chemical*, in such circumstances, market forces or government restraints are the price givers, market participants are the price takers.³⁴ It would strain precedent and antitrust theory to impose monopolization liability for small but relatively higher cost suppliers.

V. THE ROLE OF REGULATION

Regulation is a constitutionally approved alternative to competition in industries that are “affected with the public interest.”³⁵ An industry where one firm has an exclusive right to produce a particular good or service is typically referred to as a “natural monopoly.” Such exclusivity may produce efficiencies and avoid disruptive duplication of service but regulation is a necessary corollary. Regulation protects the

33. Harvey & Hogan, *supra* note 9, at 9.

34. *Brooke Group Ltd.*, 509 U.S. at 209; *Cent. Chem. Corp. v. Agrico Chem. Co.*, 531 F. Supp. 533 (D. Md. 1982).

35. *Munn v. Illinois*, 94 U.S. 113, 126 (1876).

public against the exercise of monopoly power by “natural monopolists.” At the same time, it insures that the supplier receives “reasonable compensation to enable the company to operate successfully, to maintain its financial integrity, to track capital, and to compensate its investors for the risks assumed.”³⁶ The concept of just and reasonable rates, which is embodied in section 205 of the Federal Power Act and various state regulatory statutes, permits a “reasonable rate of return” for the cost of providing non-discriminatory service for the public at large.³⁷ This is the essence of cost of service rate making. The rate to be charged to the public is based upon a rate base composed of “used and useful” capital equipment in service, together with the variable costs of providing that service, measured against expected demand for that service. The revenue necessary to achieve a “reasonable return” divided by the anticipated demand, yields a “just and reasonable rate” to be charged to various classes of customers. This process “guarantees” a reasonable rate of return and often caps a maximum rate of return. Excess profits are often returned to ratepayers.

Stability and reliability substitute for risk and reward in this environment. So long as costs are prudently incurred, subject to review by the regulator, they are included in the rate base calculation and the ratepayer bears the risk of increased cost due to changed market conditions. On the other hand, service providers are encouraged to plan prudently for changes in market conditions and to avoid exposure to undue rate increases to ratepayers. A return on capital investment is typically amortized over an extended “useful life” in order to recover a reasonable return on investments through less than market-based increased prices during periods of high demand. At the same time, this assures a reasonable return during periods of low demand for costs that were prudently incurred. In addition, some degree of cross subsidization between rate classes is often present, resulting in higher rates for commercial users and lower rates for residential users than would ordinarily occur in a competitive environment.

Regulation is designed to protect the public against “monopoly power,” not “excessive” prices during periods of high demand and insufficient supply. However, regulation has the latter effect by limiting the maximum price that can be charged without regulatory approval. Regulation is designed to avoid supply shortages by not focusing on short-term price signals, yet it has the effect of minimizing price increases whether the source is market conditions or “monopoly

36. Fed. Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 605 (1944).

37. 16 U.S.C. § 824(d) (2000).

power.” Thus, the long-term effect of regulation results in a smoothing of price swings between periods of high demand and low demand so that a more even “just and reasonable” rate is charged to consumers from one period to the next. Capacity increases in response to engineering needs, not necessarily overall economics and price signals. Yet the perceived misallocation of cost among different classes of customers and perceived inflexible pricing structure, particularly for commercial users with viable alternatives in periods of low demand, provided seeds for the current deregulation movement in the United States.³⁸

VI. DEREGULATION MEANS PRICE FLUCTUATION

The thrust of the initiative to deregulate electricity has been directed to generation. While transmission has been the subject of FERC initiatives designed to reduce control of the natural monopoly of transmission, alternative competitive transmission grids are unlikely to be built.³⁹ Similarly, while certain aspects of the distribution process may be subject to competition, particularly related services, an alternative system of wires is not contemplated. Most industry observers believe that the benefit of competition can only be derived from deregulation and open access to competitive generation.

Price fluctuations are a normal part of a competitive business. In a deregulated industry where demand changes rapidly by the hour, day and time of year, this is particularly true. In congressional hearings of June 4, 1997, James Serota stated:

Competition is like democracy—you can’t predict the outcome. Competition means that when supply exceeds demand as it does in various places on the East Coast, you should reap the benefit of competition and get lower prices. Competition does not mean that when demand exceeds supply, as it may this summer in Illinois and Wisconsin, that you then suppress competition and retain regulation.⁴⁰

38. RICHARD J. GILBERT & EDWARD P. KAHN, *Competition and Institutional Change in U.S. Electric Power Regulation*, in INTERNATIONAL COMPARISONS OF ELECTRICITY REGULATION (1996).

39. Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities, Order Nos. 888-888A, 75 F.E.R.C. ¶ 61,080, 1996 FERC LEXIS 777 (1996); Regional Transmission Organizations, 65 Fed. Reg. 809 (2000), issued as FERC Order No. 2000.

40. *Hearing Before the House Comm. on the Judiciary*, 105th Cong. 123 (1997) (statement of James Serota).

Implicit in the use of a term such as “price-gouging” during periods of price spikes are lingering traces of regulation.⁴¹ Subsumed in price regulation is the concept of just and reasonable rates. Neither rates nor profits will go too high or too low. When generating plants were divested by investor-owned utilities, they generally lost the safety net of price protection. At the time of such sales, such generators usually received market-based rate-making authority from the FERC. Implicit in the reasoning of government authorities who complain of “price gouging” is the theory that prices are too high because they are above marginal cost, i.e., they are not just and unreasonable, and they must be kept at a just and reasonable price. The proponents of such theories never argue that when the economic cycle turns down, the “putative” “price-gouging” supplier should be protected against losses.

This is reminiscent of the take or pay controversy of the late 1970s and early 1980s. Shortages occurred, and producers entered into long-term contracts for supplies of gas at prices above prior historical levels. Customers desperate for natural gas “locked up” this capacity. When the shortage ended and spot prices dropped, customers tried to avoid these high-priced agreements. They were not successful.⁴² Long term contracts to avoid the ravages of fluctuation are common in many industries. In such contracts, there is a trade-off between the possible short-term benefit of spot prices versus the long-term certainty of supply and price stability. In an unregulated environment where the consuming public has chosen to be free from regulation in order to make that trade-off an individual choice, individual consumers can make an informed choice in favor of price or stability but should not ask to be relieved of their choice if the choice does not prove wise.⁴³ In the cycle of fluctuation attendant to electricity pricing, prices must be viewed in a continuum. Monopoly pricing is not evinced by periodic, even precipitous, price spikes in response to supply shortages. Such price movement cannot be disassociated from periodic price drops below marginal costs during periods of low demand.

41. See SEABRON ADAMSON & KEVIN WELLENIUS, DETERMINATION OF HORIZONTAL MARKET POWER ABUSE IN WHOLESALE ELECTRICITY MARKETS 19-25 (Frontier Econ., Working Paper No. FE99-01, 2000). Adamson and Wellenius argue for a “no market power” standard of liability whereby rather than determine whether a particular supplier or trader has market power, regulators should determine whether the market is capable of pricing at marginal cost. *Id.* As the authors candidly admit, this is a return to price regulation. *Id.*

42. See, e.g., *Illinois ex. rel. Burris v. Panhandle E. Pipe Line Co.*, 935 F.2d 1469, 1481, 1483-85 (7th Cir. 1991).

43. Ironically, California regulators concerned with “price gouging” and capacity shortages recently entered into long term supply contracts at the market peak and are being criticized for this choice as well.

VII. MARKET RESPONSES TO "PRICE GOUGING"— THE DEREGULATION PROCESS

The deregulation of generation began when investor-owned utilities either "voluntarily" or by statute were forced to divest generation.⁴⁴ There was substantial concern that prices that would be recovered by the sale of those plants would be less than the book value of those assets.⁴⁵ This concern was based on the perception that prices and demand at that time were low, and that prices for assets in an unregulated environment would generate less revenue than in a regulated environment. Accordingly, it was thought the value of those assets, represented by the long-term profit stream from such reduced revenue, would result in a substantially reduced cost recovery for those assets. Many investor owned utilities were concerned that they would be saddled with "stranded costs" representing the difference between the regulatory value of the asset and the actual market value of the asset. While a regulated asset can be expected to pay for itself over a relatively even revenue stream, an unregulated asset stream will be the subject of high and low revenue years which are not guaranteed. If the regulation of the asset is interrupted in midstream, there may be a shortfall, a stranded or strandable cost, over the remainder of the asset's useful life. The timing of the interruption is arbitrary, but since the pressure to deregulate is often the greatest when the public benefits appear to be greatest, i.e., low demand and low prices, the expectation of a shortfall is at its peak.

In many instances that was not the case. The sale prices of the assets were equal to or more than the book value of the assets because the buyers correctly anticipated that energy prices would rise and they would recover their acquisition costs through prices that were higher than the prevailing prices in the past. Because these stranded costs were reduced and in some cases capital gains were achieved, ratepayers in those jurisdictions reaped substantial benefit in the form of lower or more stable rates than that which would otherwise have occurred due to stranded costs.⁴⁶

44. For an example of deregulation by statute, see, for example, A.B. 1890 (Chapter 854, Statutes of 1996) (deregulation in California).

45. Taylor & VanDoren, *supra* note 2, at 4.

46. See Colin Drukker, *Economic Consequences of Electricity Deregulation: A Case Study of San Diego Gas & Electric in a Deregulated Electricity Market*, 36 CAL. W. L. REV. 291, 299-300 (2000). San Diego Gas and Electric earned \$262 million capital gain due to the competitive bidding process for its Encina power plant. *Id.* at 299. This result was not isolated. Overall, SDG&E earned \$600 million in profit from the sale of its generating plants. *Id.*

If new buyers are not allowed the ability to charge whatever prices the market will bear in order to recover their asset purchase costs made in a competitive environment, it would frustrate their expectation at the time of sale and the risk which they took in believing that they could recover the value of their investment in a free market environment. A sophisticated buyer of such assets understands there will be price and demand fluctuations and factors that into its revenue model before making its bid. It would also reduce the price of any future sale of assets, as future buyers would have to consider the possibility that such assets should be discounted for the risk of reregulation.

Sophisticated sellers, particularly those with default or provider of last resort responsibility, often enter into transition contracts with sellers to assure themselves of adequate supply at a reasonable price. In the absence of that, they prudently hedge their known obligations either financially or physically. Failure to hedge for market fluctuations is not an indicia of market failure or the exercise of monopoly power that reflects on the buyer's bona fides.

Moreover, allowing such reregulation of the rates in response to precipitous price rises, i.e., "price gouging," and diminishing the acquirer's profit stream would in effect be a double windfall recovery to ratepayers as they had received the benefit discounted to present value at the time of the sale of that asset and would in effect receive the discount on the expected rates from a new regulatory cap. Had the buyers' model been incorrect, would ratepayers or their surrogates offer to tender the excess sale price to the sellers? Not likely. In the face of the current economic slowdown and reduced demand for electric power, there is no evidence that they are doing so now.

VIII. CONCLUSION

When a political choice is made for competition in favor of regulation or vice versa, the benefits and risks of each are known and understood. To impose regulatory amendments on the market without providing a regulatory floor on risk frustrates the deregulation process and distorts the concept of monopolization and monopoly pricing. "Price-gouging" is a short-term epithet of those who take only the benefits and accept no risks of competition. When a market dictates the price, the market is functioning as intended. When a seller or sellers dictate the price independent of that market, only then do the evils of monopoly arise.