Economists Incorporated
Economists INK
FALL 2016
A BRIEF ANALYSIS OF POLICY AND LITIGATION

# D.C. Circuit Upholds FCC Open Internet Order

*P. Joseph Ahn*

*Dr. P. Joseph Ahn has expertise in microeconomics, corporate strategy, and quantitative analysis, with particular focus on technology and media industries. His work has included estimating damages, analyzing proposed regulation, and advising on multi-national tax structure.*

In a 2-1 decision, the U.S. Court of Appeals for the District of Columbia (D.C. Circuit) recently upheld an order by the Federal Communications Commission (FCC) to reclassify broadband access providers as telecommunications providers subject to common carrier regulation. The FCC's decision was motivated by its support for "net neutrality," which requires that all Internet content be treated equally regardless of content or source. Net neutrality precludes Internet Service Providers (ISPs) from providing priority service to content either because they themselves produced it or because the content provider paid for better service.

This decision was the third time in seven years that the D.C. Circuit has ruled on an appeal of the FCC's attempts to support net neutrality. The FCC has continually sought different sources of authority to regulate ISPs. In its 2010 Open Internet Order (OIO), the FCC classified broadband services as regulated information services. The D.C. Circuit's rejection of that approach led to the FCC's 2015 OIO, reclassifying broadband service providers as common carriers. Although the court upheld this approach, the dissenting opinion contends that the 2015 OIO displays a disconcerting trend towards abandoning cost-benefit analysis and economic reasoning.

While some argue that the relationships between ISPs and content providers require no sector-specific rules and could be handled by the same antitrust laws as apply to other industries, the FCC was unlikely to take that approach. The FCC had three other alternatives to handling agreements to give priority service to some content: 1) case-by-case adjudication, with a presumption for such agreements; 2) case-by-case adjudication, with a presumption against such agreements, and 3) blanket prohibition on all prioritization. Case-by-case treatment has an advantage over blanket bans, as it allows legitimate business arrangements and reduces the chance of banning a procompetitive arrangement. The 2010 OIO elected the first option, but the 2015 OIO dismissed this as being too "cumbersome" to enforce. That statement is surprising, given that the FCC has adopted the case-by-case approach in other contexts, such as interconnection disputes.

Moreover, the FCC did not conduct a cost-benefit analysis of its new regulations. That is particularly disturbing because the 2010 OIO used economic models of two-sided platforms to show that zero-pricing rules banning paid prioritization, which were imposed in the 2015 OIO, had ambiguous welfare effects. Thus, the FCC has imposed regulations that have no clear economic justification, and the D.C. Circuit has allowed them the discretion to act this way.

## *Also In This Issue*

# The Supreme Court Rules on the Scope of Federal Energy Regulation

*John R. Morris and Keith Everhart*

Does the Federal Power Act (FPA) preempt a state-mandated contract that fixes the payments received by a generation developer for capacity sold in federally regulated auctions? The Supreme Court addressed that question in *Hughes v. Talen Energy*.

The question was raised because in 2011 Maryland decided that the energy and capacity auctions operated by the PJM Interconnection (PJM) did not provide sufficient incentives to promote new generation within the state. PJM operates the high voltage transmission grid in all or parts of 13 states running from the Mid-Atlantic region westward to northern Illinois. The daily energy auctions operated by PJM do not provide sufficient net revenues to maintain enough generation capacity for reliable operation. Therefore, PJM conducts forward capacity auctions to provide additional revenue.

In those auctions, PJM forecasts demand for capacity three years in the future, and generation companies submit offers to supply that capacity. The auction process produces a clearing price that is received by all generation units that clear the auction within a region. The regional component of the auction structure means that some regions that are relatively short of generation capacity, such as parts of Maryland, may have substantially higher capacity prices than regions with more abundant capacity. Despite these relatively high capacity prices, there were no new major generation additions in Maryland for many years before 2011.

> "The contracts set the net price received by CPV from selling capacity into the PJM annual capacity auctions."

To promote new generation capacity within the state, Maryland devised a plan to provide capacity suppliers a secure return on investment. It solicited offers for new generation capacity and selected an offer from Competitive Power Ventures (CPV). The plan required the three major electric distribution utilities in Maryland to enter into 20-year contracts for differences with CPV. Under these contracts, CPV would receive the guaranteed capacity price specified in its proposal, and the distribution utilities (and in effect, their retail ratepayers) would either receive or pay the difference between the contract price and the ultimate auction clearing price. For example, if the contract price were $130/MW-day and the annual capacity auction price was $150/MW-day, then CPV would pay the distribution utilities $20/MW-day for the year. If the annual capacity auction price were only $100/MW-day, then the distribution utilities would pay CPV $30/MW-day. As a result, CPV would on net receive the contract price, $130/MW-day, regardless of the prices set by the annual capacity auctions. The contracts were purely financial. That is, the distribution utilities never took title to the capacity rights of CPV's plant. The contracts set the net price received by CPV from selling capacity into the PJM annual capacity auctions.

*Dr. John R. Morris leads the energy practice at EI. Among his consulting assignments, he advises clients on the competitive effects of regulations affecting electric power capacity markets. Keith Everhart, formerly an Economist with the Federal Energy Regulatory Commission' Office of Enforcement, consults on energy matters at EI.*

The contractual arrangement was accepted by PJM and implicitly by the Federal Energy Regulatory Commission (FERC). When Maryland passed the regulations leading to the CPV contract, PJM petitioned FERC to modify the auction's Minimum Offer Pricing Rule. The revision required CPV and other similar generation companies that obtain financial assistance from states to submit data to PJM's market monitor to set a minimum offer price for the capacity auctions. FERC accepted the proposed revisions. CPV submitted the required data, and the market monitor then set a minimum offer. The auction clearing price was greater than the minimum offer, so CPV cleared the auction and was set to construct its plant and receive the benefits of the contracts with the distribution companies.

At this point an independent power producer, PPL EnergyPlus (PPL), filed suit in federal district court challenging the contracts. PPL, which was the predecessor of Talen, put forth several arguments, such as states' assisting new generation expands capacity and thus lowers capacity prices. Hence, the contracts represent an impermissible at-

*continued on page 4*

# Uber Surge Pricing Antitrust Class Action Moves Ahead

*Clarissa A. Yeap*

U.S. District Judge Jed Rakoff of Manhattan recently denied a motion to dismiss the class action lawsuit brought by a customer against Uber Technologies Inc. (Uber) CEO Travis Kalanick. The lawsuit alleges that Mr. Kalanick and other Uber drivers conspired to fix prices by agreeing to charge customers for rides according to Uber's pricing algorithm, which includes automatic price increases during periods of peak demand. Judge Rakoff later dealt a further setback to Uber when he denied Uber's attempt to force the case to arbitration. The trial is set to begin on November 1, with the key decisions hinging on what role Uber plays in the ride-sharing market and how surge pricing affects consumer welfare.

According to Uber, it is a technology company whose main product is a ride-sharing app that connects drivers with customers. Uber drivers are independent contractors, not employees of the company. In addition to matching drivers to riders, the Uber app calculates the fare for each ride using a proprietary algorithm and manages the payment transaction. Uber retains a percentage of each fare as payment for licensing its software. Uber's pricing algorithm includes price "surges" or increases in periods of high demand, such as during inclement weather, or on peak travel days, such as New Year's Eve.

The lawsuit alleges that Uber's and its drivers' use of the pricing algorithm amounts to price fixing since they have bound themselves to charging a standard fare and uniform surge pricing when demand is high. The lawsuit alleges both horizontal and vertical price fixing claims. Mr. Kalanick is alleged to be the organizer of the conspiracy in his role as Uber's CEO and also a co-conspirator in his role as occasional Uber driver. Uber argued that the horizontal price-fixing claims should be dismissed because Uber plays no role in the transportation industry but rather supplies ride-matching and payment-processing services to the industry through its software. It claims that drivers independently choose to use Uber's app to benefit from these services. Judge Rakoff did not find this argument to be sufficient reason to dismiss the horizontal claims, pointing to the recent *United States v. Apple, Inc.* (ebooks) ruling as a case where a party to a vertical relationship was found to have orchestrated a horizontal agreement in restraint of trade. In so doing, Judge Rakoff drew a direct comparison between the role of Uber in facilitating ride-sharing and the role of Apple's iBooks platform in facilitating ebook sales.

> "How Uber's business model is viewed relative to the ride-sharing market in this case has wider implications for other technology firms."

In both cases, economists would say that Uber and Apple performed the function of a two-sided platform, bringing together buyers and sellers of shared rides and ebooks, respectively. Whether or not the court ultimately views Uber as a two-sided platform will affect the findings concerning horizontal or vertical price-fixing. Horizontal price fixing is per se illegal. If Uber is viewed as a two-sided platform, however, its business model includes vertical coordination with drivers, and vertical conduct is assessed by the courts under the rule of reason standard. Competitive effects of Uber's pricing algorithm and surge pricing would be evaluated for their overall effect on consumer welfare.

Uber argues that surge pricing helps to ensure shorter waiting times for customers who are willing to pay the higher prices by moderating demand and creating incentives for more drivers to participate. Economic theory contends that when demand outstrips supply, prices in a free market will adjust until a new equilibrium is reached where demand meets supply. A mechanism such as Uber's surge pricing could mimic the actions of a free market and drive the ride-sharing market towards greater efficiency. In particular, Uber's pricing algorithm could play a crucial role in generating better matches between riders and drivers in Uber's function as a two-sided platform. On the riders' side of the market, higher fares may cause customers who do not value rides as highly to wait for surge pricing to end, lowering the amount demanded. On the drivers' side of the market, higher fares may lead more drivers to offer their services, increasing the amount supplied. The key question for assessing the anticompetitive harm is whether overall consumer welfare actually increases

*EI Senior Economist Clarissa A. Yeap specializes in empirical microeconomic analysis in the assessment of liability and damages in antitrust, intellectual property and class action matters.*

*continued on page 4*

## Scope of Federal Energy Regulation

tempt by the state to influence the auction clearing prices. The argument that had the most traction, however, was the argument that the contracts "fix" the capacity price and that a state cannot fix a price that is under the exclusive jurisdiction of FERC. Accordingly, the district court found for PPL, and the Fourth Circuit affirmed the district court decision.

Maryland and CPV petitioned the Supreme Court to review the appellate decision. They argued that CPV, not Maryland, set the rate. That is, in competition with other companies, CPV offered to provide new generation capacity at a certain capacity price. The contracts at issue are simply bilateral contracts between CPV and the distribution utilities. Because bilateral contracts are allowed in tandem with the PJM capacity auctions, the contracts at issue are perfectly acceptable. Moreover, the FPA pertains to jurisdictional sellers (e.g., CPV) and not to the respective counterparties. Hence, FERC has no jurisdiction over Maryland's decision to compel the distribution utilities to contract with CPV. The FPA leaves to the states to decide how much generation is necessary for reliability in the state.

The Supreme Court disagreed. Three facts seemed to sway the Court. First, the contracts went into effect only if the CPV capacity cleared the PJM capacity auction. This fact indicated to the Court that the purpose of the contracts was to fix the auction prices, and not create their own, independent, bilateral prices. Second, the contracts effectively fix the capacity payment to CPV. That is, regardless of the prices established in the PJM capacity auction, CPV would receive the same capacity payment. Third, the contracts were purely financial. In a physical bilateral contract, the purchasers (i.e., the distribution utilities) would take title to the capacity rights, and they would be responsible for offering the capacity to the PJM capacity auctions. In this case, however, CPV kept the capacity rights and offered them to PJM. Hence, the nature of the contracts was to fix the payments for capacity that CPV sold to PJM via the capacity auctions. In that sense, the contracts "fixed" the capacity prices. The Court concluded that "[b]y adjusting an interstate wholesale rate, Maryland's program invades FERC's regulatory turf."

## Uber Surge Pricing

due to surge pricing. The answer depends on how responsive drivers are when fares rise during surge pricing periods. If the supply of rides does not respond and riders face both limited supply and increased prices for extended periods of surge pricing, consumer welfare may be harmed by Uber's pricing algorithm. If, instead, surge prices increase supply enough that the non-price benefit of short wait times offsets the price increases and prices fall back quickly, then Uber's pricing algorithm increases consumer welfare. Currently there is little public information to assess this question.

How Uber's business model is viewed relative to the ride-sharing market in this case has wider implications for other technology firms. Many large technology companies like Apple, Amazon, and Airbnb play the role of two-sided platforms, bringing together suppliers and buyers of goods or services. They often position themselves as suppliers of innovative technology for facilitating better matches, such as Uber's surge pricing mechanism, and keep at arm's length from the industries they serve, as Uber does by designating drivers as independent contractors rather than employees. In some cases, this strategy allows the firms to avoid regulatory oversight or employment laws. Companies like Uber may face increased regulation if the courts begin to view them as key participants in the industries that use their services, regardless of their arm's length relationships with market participants. For example, for Uber, the antitrust case could also affect lawsuits brought by drivers who were seeking to be classified as employees and regulators who are interested in examining Uber's labor practices.

In the opinion denying the defendant's motion to dismiss, the judge noted that "[t]he advancement of technological means for the orchestration of large-scale price-fixing conspiracies need not leave antitrust law behind." This statement touches on a key tension in how "new economy" firms like Uber should be viewed, whether as disruptors of traditional business models that raise efficiency for society as a whole, or as the latest players with new tools to achieve the age-old nefarious goal of conspiring to reduce competition.

# *EI News and Notes*

## Monopolization Claim Rejected

EI Chairman Barry C. Harris testified in federal court in Madison, Wisconsin on behalf of Inguran, LLC and XY LLC on antitrust liability issues. Inguran and XY were rebutting antitrust claims filed by ABS Global Inc. ABS alleged monopolization in a market for sexed bovine semen processing. Dr. Harris testified concerning market definition and competitive effects. He presented evidence of declining prices, increasing quality and increasing sales of the products involved in the case. Dr. Harris also testified about the role of patents and long-term contracts in competition. The jury found for Inguran and XY. EI economists Stephanie Mirrow, Michael Baumann, and Allison Holt worked with Dr. Harris. Inguran and XY were represented by Akin, Gump, Strauss, Hauer & Feld.

## Court Certifies Class

The U.S. District Court in Atlanta recently certified a consumer class in an antitrust case alleging that Delta Airlines and AirTran Airways colluded to impose baggage fees. EI Principal Hal J. Singer testified for the class and presented econometric evidence supporting the plaintiffs' arguments of common injury. The court rejected a motion to exclude his testimony on Daubert grounds. Dr. Singer was assisted by EI Senior Economist Kevin W. Caves. Plaintiffs were represented by the firms of Kotchen & Lowe and Berger & Montague, among others.

## Six EI Economists in Who's Who of Competition Lawyers and Economics

Principal William Hall, Board Chairman Barry Harris, Principal Joseph McAnneny, Principal William Myslinski, Principal Philip Nelson and Special Consultant Bruce Owen are included in the latest edition of *The International Who's Who of Competition Lawyers and Economists 2016*. Economists are selected for inclusion based on Global Competition Review's independent surveys of general counsels and private practice lawyers worldwide.

Economists
INCORPORATED

OFFICES:

2121 K Street, NW
Suite 1100
Washington, DC 20037
phone: (202) 223-4700
fax: (202) 296-7138

101 Mission Street
Suite 1000
San Francisco, CA 94105
phone: (415) 975-5510
fax: (415) 281-9151

1276 Metropolitan Blvd.
Suite 303
Tallahassee, FL 32312
phone: (850) 558-6030

www.ei.com

President
*Jonathan L. Walker*

Editor
*Henry B. McFarland*

in association with
The Allen Consulting Group in Australia