12th Annual American Antitrust Institute Energy Roundtable

Summary of Proceedings

I. Introduction

The American Antitrust Institute (AAI) held its 12th Annual Energy Roundtable on April 24, 2012 at the National Rural Electric Cooperative Association (NRECA) in Arlington, Virginia. The AAI greatly appreciates the generous assistance and sponsorship of both NRECA and the American Public Power Association (APPA) in making the Roundtable possible. The AAI's Annual Energy Roundtable seeks to bring together various stakeholders and perspectives to discuss current competition policy issues in electricity markets, particularly the intersection between antitrust and regulation. This year's Roundtable focused on electricity mergers, analytical approaches to understanding their competitive effects, and federal and state agency practices in reviewing them. More than 40 participants from academia, advocacy, consulting, government, industry, and trade associations participate in the Roundtable. AAI Vice President and Director, Diana Moss, developed the agenda and presided over the discussion. The proceedings themselves were off the record and not transcribed. This report briefly summarizes the presentations and accompanying discussion. [1]

The following speakers made presentations:

1. David Mohre, Executive Director, Energy & Power Division, National Rural Electric Cooperative Association
2. Joseph Bowring, President, Monitoring Analytics
3. John Shelk, President and CEO, Electric Power Supply Association
4. John P. Coyle, Partner, Duncan & Allen
5. Donna Kooperstein, Senior Counsel, King & Spalding
6. Paula Carmody, People's Counsel, Maryland Office of People's Counsel
7. Steve Rodgers, Director, Division of Electric Power Regulation – West, Federal Energy Regulatory Commission
8. Tracy Fisher, Trial Attorney, U.S. Department of Justice, Antitrust Division

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[1] The summary of proceedings was prepared by Sandeep Vaheesan, Associate at the Washington D.C. office of Vinson & Elkins.

II. Year In Review

David Mohre opened the Roundtable with a recap of the year's major events in electricity and energy and a forecast of coming issues. The U.S. will likely have more than enough generation capacity for the foreseeable future and nationwide reserve margins are above reliability requirements. While demand growth is projected to be flat as a result of slow economic growth, efficiency measures, and demand response, upward pressure from the proliferation of electric cars, energy storage, and increased electrification cannot be ruled out. The supply side could witness changes in the upcoming years. Cheap natural gas, Environmental Protection Agency (EPA) rules on greenhouse gas emissions, and state-level renewable portfolio standards could alter the fuel mix of the generation portfolio. Natural gas generation could displace coal-fired generation as up to 73,000 megawatts of coal capacity could be retired under the proposed EPA rules. Low natural gas prices and efficient combined cycle technology make new natural gas generation cheaper to build and operate than coal. In contrast, new wind generation remains more expensive than coal and natural gas due to its intermittency and associated transmission requirements.

III. Highlights of the Morning Presentations

A. Morning Panel: What are the Emerging Issues for Electricity Merger Analytics?

Joseph Bowring offered the PJM independent market monitor's perspective. Region-wide and locational market power issues are important in energy markets, as is the presence of 4-5 pivotal suppliers and endemic market power in the capacity market. Given the reality of smaller geographic markets resulting from transmission constraints and locational market power, unit impact factors are important to consider. HHI statistics and pivotal supplier tests can produce very different results (e.g., market-wide HHIs are lower even though relatively few suppliers are pivotal). The pivotal supplier test may therefore offer a more accurate picture of market dynamics than HHI statistics. Bowring reviewed the mix of structural and behavioral remedies in the Exelon-Constellation merger, noting that structural remedies are typically the best solution but may not always be sufficient to promote competition. Divestitures in Exelon-Constellation included limitations on asset sales to suppliers whose acquisition of the units could increase market concentration, while behavioral remedies were designed to address the threat of economic and physical capacity withholding. Bowring concluded by noting that market mitigation rules are imperfect, so it is better to get market structures and incentives right through merger review. The focus should be on removing barriers to entry, creating incentives for innovation, and promoting dynamic competition rather than static efficiency. Bigger questions to be answered include defining the goal of restructuring, whether RTO membership should be mandatory, and whether vertical integration should continue.

John Shelk began with comments on demand response programs, emphasizing that the definition of demand response needs to be clarified (e.g., is a megawatt of demand

reduction equivalent to a megawatt of supply?) and whether consumers should be compensated with locational marginal prices for demand response. Shelk noted that buyer power and adequate revenues for generators remain an issue in electricity capacity markets. Policies to lower capacity prices in Maryland and New Jersey would have reduced capacity markets revenues by nearly 50 percent had they been in effect in 2010. Moreover, new capacity in New York City has led to a collapse in prices in the capacity market. Shelk noted that competition from regulated and governmental entities also represents a potential challenge to independent power producers. For example, utility proposals to build new capacity and avoid renewing IPP contracts will leave IPP investments "stranded." A proposed transmission line from Canada to New York City would mean that IPPs may soon compete against publicly owned Canadian generation companies. Finally, the Department of Defense has proposed building generating capacity on military bases, with the intention of selling the surplus power into wholesale markets.

John Coyle observed that the past twenty-five years have witnessed significant consolidation in the electric power industry. He noted that the Federal Energy Regulatory Commission (FERC) recently declined to adopt the 2010 Department of Justice (DOJ)/Federal Trade Commission (FTC) Horizontal Merger Guidelines (Guidelines), likely because the Commission has more confidence in the previous version, or believes that they have not been an obstacle to industry consolidation. Coyle noted that the existing "clock" on FERC review of merger deters potential intervenors from participating in the process. Coyle raised questions regarding demand response, noting that significant reductions in peak demand are only a theoretical possibility and that it should not be assumed that actual demand response equals expected demand response. Coyle concluded with the analogy that over the past fifty years, beer mergers have eliminated variety and given rise to mediocre mass-market brands but recently, specialty beers have created niche markets. In more recent decades, electric utilities have similarly merged to create regional behemoths but consolidation could spur a backlash, perhaps in the form of more municipal cooperatives. If merger review slows consolidation, it may allow such alternative arrangements to flourish.

B. Morning Discussion

The morning discussion focused on the role of demand response in market definition, competitive effects, and consumer choice.

- ***The role of demand response:*** Several participants noted that demand response resources should be carefully defined and not automatically equated with supply resources. Some forms of demand response are clearly substitutes for supply but others (e.g., real-time pricing) are quite distinct from supply. Another participant added that demand response can increase the elasticity of demand and reduce incentives for withholding by generators. It was noted that the notion of completely inelastic demand is not realistic because load-serving entities already have significant demand response programs in place and have caused the deferment of some supply-side investments.

- ***Data availability:*** The discussion then turned to the merger review process. One participant noted that analysis in non-RTO markets is somewhat impaired by a lack of data. In contrast, more detailed market analysis is possible in RTO markets because of data on prices, transmission availability, etc. FERC disclosure of Form 715 data to parties who sign non-disclosure agreements would allow intervenors to play a larger role in merger proceedings.

- ***Consumer choice issues:*** Real-time pricing and retail choice also arose in the morning roundtable discussion. One participant noted that accurate price signals are necessary to induce the correct levels of investment in demand response and distributed generation. Another participant mentioned that reliability needs differ across market participants (e.g., microchip manufacturing plant vs. typical household). One participant, however, noted that the realities of human behavior are important in the choice debate. For example, customers are accustomed to existing utility practices and would be unhappy with radical changes in pricing. Moreover, when presented with retail choice, many utility customers remain with their existing provider.

IV. Luncheon Address

Donna Kooperstein's luncheon address focused on differences between the DOJ and FERC processes for reviewing electricity mergers. As an enforcement agency, DOJ must seek a court injunction to block a transaction whereas FERC does not have to go to court. Unlike the DOJ and Federal Communications Commission (FCC), which collaborate frequently on telecommunications mergers, DOJ and FERC have typically worked independently. This increases the risk of conflicting remedies and highlights the substantive differences between DOJ and FERC review. For example, DOJ looks at the likely effect on competition while FERC applies a broader "public interest" standard. In addition, the DOJ follows the more fact-specific 2010 DOJ/FTC Guidelines while FERC follows the more formulaic Merger Policy Statement based on the 1992 DOJ/FTC Guidelines. DOJ prefers structural remedies in horizontal mergers while FERC often uses behavioral remedies.

Kooperstein contended that there are good reasons for eliminating the present concurrent jurisdiction. Merging parties would benefit from the elimination of multiple filings, would be unable to play off DOJ and FERC against each other, and the threat of conflicting remedies would be eliminated. At present, however, the best outcome is consistent remedies with unnecessary administrative duplication. Kooperstein noted that because DOJ and FTC are antitrust specialists, they are therefore best suited to perform merger reviews. Even with sole jurisdiction, however, they could consult with industry regulators as necessary. A friendly critic pointed out that successful deregulation in other industries has been premised on vigorous antitrust enforcement. In electricity, however, antitrust has limited power to remedy anticompetitive behavior. More broadly conceived competition policy, rather than antitrust alone, should play a major role in realizing the

benefits of electricity restructuring, which suggests that regulators need to play a role along with the antitrust agencies.

V. Highlights of the Afternoon Presentations

A. What the Major Challenges for Electricity Merger Enforcement?

Paula Carmody discussed the role of the Maryland Office of People's Counsel (OPC) in electricity mergers. The OPC is an intervenor in proceedings at the Maryland Public Service Commission (PSC) where the merger review standard requires that a transaction both produce consumer benefits and impose no harm on the public. Carmody made a number of observations on the Exelon-Constellation merger. For example, the parties owned significant capacity and adjacent load-serving entities in Maryland and the merger would have led to "unjust and unreasonable retail rates." The PSC required the parties to make physical and virtual divestitures and to build new capacity to make up for anticipated retirements of coal-fired units. The PSC can bring enforcement actions to remedy violations of behavioral conditions. Carmody noted that the higher HHI thresholds in the 2010 DOJ/FTC Guidelines are not appropriate for electricity and that FERC acted wisely in retaining the lower thresholds reflected in the Merger Policy Statement. Carmody concluded with the observation that consumer advocates are much more active at the state level than at the federal level and that state regulators are more likely than their federal counterparts to consider the views of consumer organizations in decision-making.

Steve Rodgers explained FERC's rationale in retaining the 1992 DOJ/FTC Guidelines as the basis for FERC's merger review under the Merger Policy Statement. FERC would have a difficult time performing the types of analysis articulated in the 2010 DOJ/FTC Guidelines since it must ordinarily issue a decision within 180 days and process 130 Section 203 applications per year. Rogers noted that FERC does not look exclusively at HHIs and has focused more on the merging parties' ability and incentive to exercise market power in recent years. In addition, merger applicants and intervenors can argue why FERC should look beyond HHIs in a particular matter. Rodgers noted that regulatory certainty is important to both utilities and intervenors. Clarity on rules also helps deter many problematic mergers since parties contemplating anticompetitive mergers often do not pursue them, knowing that they will unlikely to be approved by FERC.

Tracy Fisher explained that the 2010 DOJ/FTC Guidelines represent long-time DOJ and FTC practice rather than something new. In energy markets, DOJ focuses on competitive effects and does not rely exclusively on HHIs. In non-RTO markets, however, this effects-based analysis is difficult to perform given the relative lack of data. When analyzing mergers in regions of the country without organized markets, DOJ talks to customers, identifies potential suppliers, etc. – similar to what it does in most non-electricity mergers. Fisher noted that DOJ is interested in increased cooperation with FERC but both agencies must follow confidentiality procedures. At this point, however, DOJ-FERC cooperation is not like the close cooperation between the DOJ and FCC.

Important substantive differences also remain and yet, despite all the differences, DOJ and FERC have increasingly converged on outcomes.

b. Afternoon Discussion

The afternoon discussion focused on various aspects of mergers and merger review by the DOJ and FERC.

- ***Retail effects of mergers:*** A participant opened the afternoon discussion with a brief overview of mergers between geographically adjacent utilities, noting that on the retail side, mergers between contiguous utilities can hinder economic development because the firms no longer compete to attract industrial customers through lower rates. Until now, this concern has been largely theoretical because mergers between contiguous utilities have occurred in areas unlikely to attract new industrial development.

- ***Merger retrospectives:*** A participant asked whether FERC and DOJ conduct retrospective analyses of mergers. A responder noted that oversight is built into its market-based rate reauthorization process, since applicants must re-apply every three years. Section 203(b) of the Federal Power Act also gives FERC the authority to analyze consummated transactions. Informational and resource limitations can limit DOJ's ability to perform merger retrospectives. Under the 2010 DOJ/FTC Guidelines, DOJ uses natural experiments to predict how a pending merger will likely affect competition.

- ***Role of real-time pricing and long-term contracts in counteracting market power:*** One participant suggested that providing accurate price signals to ratepayers would increase the elasticity of demand and potentially counteract the exercise of market power. One responder asked why consumers should have the burden of counteracting generator market power since electricity is an essential commodity and it is easy to overstate how much residential customers can change their consumption patterns. Similarly, one participant queried the group on the role of long-term contracts for customers who remain with the default retailer, pointing out that the auction in Maryland in 2005 led to significant rate increases for retail customers and that getting the bid solicitation process right is critical.