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The American
Antitrust Institute

November 15, 2002

VIA ELECTRONIC FILING

The Honorable Magalie R. Salas
Secretary
Federal Energy Regulatory Commission
888 First Street NE
Washington, DC 20426

RE: Docket No. RM01-12-000: Remedying Undue Discrimination Through Open Access Transmission Service and Standard Electricity Market Design, Notice of Proposed Rulemaking

Dear Ms. Salas:

Forwarded herewith are Comments of the American Antitrust Institute in the above-captioned proceeding.

Sincerely,

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UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Remedying Undue Discrimination
Through Open Access Transmission Service
and Standard Electricity Market Design
Notice of Proposed Rulemaking

Docket No. RM01-12-000

COMMENTS
OF THE
AMERICAN ANTITRUST INSTITUTE

The American Antitrust Institute (AAI) appreciates the opportunity to comment on the Commission's Notice of Proposed Rulemaking regarding remedying undue discrimination through open access transmission service and standard electricity market design. Per the Commission's request, we note that the AAI's comments respond to paragraph numbers 390 through 461 of the proposed rulemaking.

The focus of the AAI's comments is on The AAI is an independent, non-profit education, research, and advocacy organization that supports a positive role for antitrust in the national economy.¹ The AAI's mission is to advocate policies that increase the role of competition, assure that competition is fair, and challenge the undue concentration of market power in the economy.

The economy of the United States has been restructured over the past thirty years as a result of public policy decisions to deregulate key industries and thereby free up market forces previously constrained by regulatory frameworks. We now have sufficient experience with such industries as transportation and telecommunications to recognize that deregulation

¹ Information about AAI is available at www.antitrustinstitute.org.

can indeed be beneficial in terms of promoting efficiency, reducing prices, and spurring innovation. But we have also learned that competitive industries are not easily achieved where monopoly had previously reigned and where the goal of efficiency in allocating goods and services may not necessarily produce the most desirable outcomes.

In particular, if the competitive framework is to work, both antitrust and regulation should have integral roles from an early stage. For antitrust enforcement, this means continuing to identify and redress abuse. For regulation, this means a shift to market “oversight and enforcement” by developing policies to promote competitive outcomes and enforcing the rules of conduct.

I. The proposal appropriately recognizes that full deregulation of the U.S. electric power industry is not feasible and that competition will have to be carefully “managed”

Much has been learned about electricity markets in the U.S. over the last ten years. During this period there has been a shift from cost-based to market-based prices, massive churn in generating assets through M&A, vertical integration into fuel supply, failed experiments with retail access and market design, the collapse and exit of former “mavericks” in the industry, and increasing stress on critical but inadequate transmission infrastructure.

Perhaps the most important realization is that the expected outcome of regulatory reform in the U.S. electric power industry is not what it was even two or three years ago. The goal of markets that deliver the benefits of competitive prices, innovation and consumer choice without government intervention is worthy indeed. But recent history tells us that ideology must make room for realism and pragmatism. Electricity is like no other product consumed in the modern economy. It is necessary for economic well-being, safety and health; it cannot be stored; its demand varies continuously and often significantly over the

course of an ordinary day; and it relies on massive and controversial physical infrastructure for delivery to consumers. Moreover, in many cases where states have tried retail access, consumers have sent a strong message that they do not prefer “choice.” Rather, they prefer a single supplier to do their power supply shopping for them. These qualities do not make electricity a good candidate for the type of full deregulation envisioned until recently.

The AAI applauds the Commission for acknowledging, in essence, that because the transition phase of regulatory reform is a long and arduous process, it is increasingly unlikely that pure laissez-faire competition will prevail at the end of the day. Rather, it is likely that competition will have to be carefully managed with regulatory policy and antitrust enforcement playing complementary roles.² Regulatory policy under managed competition plays a stronger role than it would in a purely free market and should--as the Commission envisions--focus on getting the incentives right. This first step in a badly needed mid-course correction to “reform the regulatory reform process” puts reform on a more even keel so that its benefits will flow more quickly to market participants.

II. Market monitors bear a disproportionately high burden under the SMD proposal

The Commission’s SMD proposal imposes a huge burden on the market monitoring units (MMUs) of Independent Transmission Providers (ITPs) for ensuring that standardized markets function properly. The Commission states that MMUs will be required to assess four broad areas: market structure, participant behavior, market design, and market power

² For a more detailed examination of this issue, see Albert Foer and Diana Moss, “Electricity and the Transitional Phase of Regulatory Reform: Implications for Regulation and Antitrust,” American Antitrust Institute, August 2002, available at: <http://www.antitrustinstitute.org>.

mitigation.³ The SMD proposal's requirements for MMUs further break down into eight significant tasks:

1. Perform regional structural competitive market analysis before implementation of SMD to identify conditions that create local market power and annually thereafter to reassess market conditions and adjust mitigation. This analysis would evaluate: market concentration; entry conditions; demand response; and transmission constraints and load pockets.
2. Perform an annual assessment of market performance. This analysis includes: a description of market operations, supply and demand, and prices; analysis of market structure and participant behavior; evaluation of the effectiveness of mitigation measures; overall assessment of market efficiency (perhaps using a simulated competitive benchmark as some have developed); evaluation of barriers to entry for generating, demand-side, and transmission resources; recommended changes to market design or market power mitigation measures to improve market performance.
3. Collect and verify data from generating units to establish appropriate caps for energy bid values.
4. Annually assess the effectiveness of mitigation actions.
5. Annually review the terms, conditions, and bid caps in the participating generator agreements.
6. Engage in surveillance to insure that market participants comply with the rules.
7. Play a key role in the enforcement of market rules by reporting to and coordinating with the Commission regarding any instances of conduct that appear to be inconsistent with the ITP's tariff.
8. Possibly monitor the ITP's operations (in addition to the markets and the market participants) to determine if the ITP is treating market participants neutrally.

Charging the individual MMU for each ITP with the responsibilities listed above appears to be an integral part of what the Commission seeks in its clearly decentralized SMD approach. The Commission envisions its role as limited to developing (ultimately) the essential elements of a standard market monitoring plan.⁴ Monitors would report directly to

³ The Commission notes that MMUs must have adequate authority to investigate participant conduct in the markets.

⁴ See ¶ 435 at p. 243.

the Commission, to the governing board of the ITP, and also be required to share certain information with regional state advisory committees.⁵

One gray area in the SMD proposal is authority. While the proposal sets forth numerous procedures, it never states that either the Commission or governing board of the ITP is the higher authority. The AAI suggests that the Commission—as part of its oversight role in implementing SMD—should be the higher authority. FERC is in the best position to make the ultimate calls on disputed issues that will inevitably arise. Moreover, the Commission represents the public in a broader way than could any ITP in an industry where localized market problems can have regional or even national impact.

A second gray area in the SMD proposal is the Commission's role. A decentralized approach to SMD would make use of the Commission's resources where it has the comparative advantage to perform "oversight." Good "oversight" is not limited to coming up with the basic elements of a standardized monitoring plan and then, in turn-key fashion, handing it over to the MMUs. To do so takes the Commission dangerously out of the loop on functions it could and should perform in order to be an effective oversight body. It also loads up the MMUs with extensive tasks for which they are likely to have inadequate resources, little comparative advantage, and which will divert their attention from the business of monitoring for and mitigating the exercise of market power.

The AAI suggests that it may be useful, therefore, to limit MMU responsibilities exclusively to monitoring and mitigation. Monitoring is examining and determining whether market conduct (i.e., market participants' behavior) is anticompetitive. Mitigation corrects anticompetitive behavior. The Commission, on the other hand, should be concerned with evaluating market structure and some aspects of market performance.

⁵ See ¶ 555 at p. 295. It is not clear from the proposal how disputes regarding any aspect of the MMUs responsibilities, data collection, analyses, or actions, will be ultimately decided.

The Commission has, by far, the greatest experience in analyzing the structure of regional U.S. electricity markets. During the period 1996 through the present, for example, the Commission evaluated dozens of merger applications, a major component of which is the definition and structural analysis of relevant antitrust markets. This wealth of knowledge means that the Commission already knows where the load pockets are, what areas are currently and likely to be transmission-constrained, and the major concentrations of generation ownership. Moreover, with this knowledge, the Commission is in a unique position to compare and contrast the features of different markets and monitor changes in market structure from “10,000 feet” and ensure a high degree of consistency in analysis perform across regions.

What the SMD proposal calls market “performance” analysis in fact contains many elements of structural market analysis. For example, evaluating barriers to entry for generation, transmission, and demand-side resources should revert to the Commission as part of their oversight function. In addition, the Commission is also in the best position to carry out assessments of regional market efficiency. Like performing structural market analysis, this would invaluablely inform the Commission’s broader perspective on the effectiveness of SMD, enable comparisons and contrasts across regions, and ensure consistency in how market performance is analyzed.

In sum, the AAI believes that the SMD final rule should articulate a strong role for MMUs that is limited to assessing and correcting market behavior and a strong oversight role for the Commission. To enable the MMUs to carry out effective market monitoring and mitigation, the final rule should set forth detailed criteria for communicating (a) the results of the Commission’s market structure and performance analysis to MMUs and (b) feedback from MMUs to the Commission.

III. The SMD proposal should not, among other things, side-step the issue of defining markets, market power or characterize regulatory intervention as “mitigation”

The SMD proposal takes an approach to monitoring and mitigation that relies on the analysis of market structure, conduct and performance. This three-part paradigm motivated the economic analysis of market in the early days of industrial organization theory. An emphasis on market structure, followed by analysis of competitive effects comports with the general approach taken by the antitrust agencies (e.g., in the DOJ/FTC 1992 Horizontal Merger Guidelines (Guidelines)). What makes this approach work, however, is that it is predicated on clear principles of market definition, what constitutes a market that is conducive to competitive outcomes, and a widely accepted definition of market power. That these principles appear in merger guidelines takes nothing away from the fact that they can be equally applicable in non-merger situations.

The Commission’s proposal goes some of the way in reaching this end, but stops short of the mark. In particular, there are four features of the SMD proposal that may not work very well in identifying and preventing anticompetitive conduct and ultimately promoting just and reasonable rates.

First, the proposal defines market power as “. . .the ability to raise price above the competitive level.”⁶ This is, at best, a loose definition of market power by antitrust standards. What seems to motivate this approach is an implicit discomfort with defining market power in the electric power industry. The Commission rightly acknowledges all the contributing factors that make this a hard—but not impossible--call: deciding on what price to use as a competitive benchmark, identifying the source of unilateral market power, and ensuring that intervention doesn’t erroneously target transient price increases (e.g., short-term price

⁶ See ¶ 393 at p. 219.

spikes).⁷ However, any definition of market power should consider the importance of a sustained and profitable price increase that is an integral part of a (e.g., Guidelines) definition of market power. Moreover, it focuses exclusively on unilateral exercise of market power through physical or economic withholding, thus overlooking the possibility of coordinated action.⁸

The SMD proposal also sidesteps the important first step in structural market analysis—defining markets. Without clearly defined product and geographic markets, no accurate assessment can be made regarding whether those markets are conducive to competitive outcomes and what competitive effects (i.e., types of market conduct) are likely within those markets.

The AAI strongly suggests that the SMD final rule provide definitions of market power, clear criteria and proposed methods for market definition, and guidance on what constitutes competitive market conditions that draw from principles set forth in the antitrust guidelines. Reference to these principles (such as those articulated in the Guidelines) would be immensely helpful in defining relevant product and geographic markets, market power and its exercise (both unilateral and coordinated), levels of market concentration which raise competitive concerns, and conditions under which entry would discipline anticompetitive price increases. Moreover, the AAI suggests that the SMD final rule address the very likely outcome that structural analysis will reveal markets that are not conducive to competitive outcomes (i.e., that are highly concentrated). The proposed rulemaking should address what the Commission proposes to do in these cases.

A second potentially troubling feature of the SMD proposal is that the Commission's objective in mitigating market power is to ensure that long-term prices (i.e., the period over

⁷ See ¶ 393 at p. 219.

⁸ See ¶ 393 at p. 219.

which variable and fixed costs can be recovered) are competitive. If this is indeed what the Commission envisions, such an objective—if operationalized—would overlook the importance of pricing decisions in the short-run on long-run market outcomes. Pricing decisions in the short-run, particularly if they reflect market power, send important signals to incumbents and potential entrants in an industry. Those price signals will influence firm entry and exit, expansion decisions and, ultimately, how prices evolve over the longer-term. In the SMD final rule, the Commission should acknowledge these basic principles and modify its objectives accordingly.

A third problem is that two of the four mechanisms for mitigating market power proposed under SMD are really not mitigation at all. For example, two proposed “mitigation” mechanisms will always be “on” (i.e., in place). There are (1) a safety-net bid cap (e.g., \$1000/MW-hr) to address the lack of price-responsive demand and (2) a resource adequacy requirement to reduce the incentive and ability to withhold output.⁹ These mechanisms reflect an implicit acknowledgement that electricity is a necessary commodity, shortages are costly, and it should always be available at prices below \$1,000 (MW-hr). These mechanisms are not market power mitigation, per se. They simply reflect the current political economy of the electricity industry and are a responsive form of regulatory intervention. Therefore, the AAI recommends that Commission recognize these measures for what they are and distinguish them from bona fide mitigation measures.

The remaining two mitigation mechanisms are not always “on” and rely on some sort of trigger criteria. These mechanisms are (1) a must-offer requirement and bid-cap for certain generators under a participating generator agreement to address localized market power and (2) possibly limiting bids from individual suppliers into the day-ahead and real-

⁹ See ¶ 400-401 at p. 223.

time spot markets if those bids are high due to withholding rather than scarcity.¹⁰ The Commission requests comment on what should trigger these mechanisms and notes several possibilities--non-competitive market conditions, a sustained period of prices significantly above competitive levels, or infrastructure problems such as sustained tight reserve conditions.¹¹ As suggested earlier, the AAI recommends that guidance on market definition, definitions of market power, descriptions of competitive market conditions, and entry ultimately contained in the SMD final rule draw from principles set forth in the antitrust guidelines.

The fourth and final problem with the SMD proposal's approach to mitigating market power is that it fails to articulate that there will be a necessary complementarity between regulatory policy and antitrust enforcement in the new SMD world. The Commission notes in its SMD proposal that:

“To be effective, market power mitigation measures must be applied before the fact, since remedies after the withholding has occurred are disruptive to the market and increase regulatory risk to its participants, which increases costs to customers.”¹²

Intended or not, the after-the-fact remedies to which the Commission refers are what antitrust enforcement actions will produce. These enforcement actions have occurred regularly over the last several decades and should be expected to continue in the future, for good reason. For example, antitrust enforcement has a different standard (no harm to competition) than does regulatory enforcement (just and reasonable rates). Moreover, any monitoring and mitigation plan—whether it is based on SMD or other framework—is not perfect. There is likely to be market conduct that either the DOJ or market stakeholder will wish to investigate if it is suspected to be anticompetitive. The AAI recommends

¹⁰ See ¶ 399 and 402 at pp. 222 and 224.

¹¹ See ¶ 402 at p. 224 and ¶ 411 at p. 229.

¹² See ¶ 396 at p. 221.

therefore that it is important for the SMD final rule to acknowledge that antitrust enforcement will (and should) play an important complementary rule to regulatory oversight in standardized markets.

Respectfully submitted,

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