UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Acquisition and Disposition of Merchant Generation Assets by Public Utilities	Docket No. PL04-9-000

I would like to thank the Commission for inviting me here today to share the American Antitrust Institute's (AAI's) views on competitive issues raised by the acquisition and disposition of merchant generation assets by public utilities. AAI is a Washington, D.C. based non-profit education, research, and advocacy organization. AAI's mission is to increase the role of competition, assure that competition works in the interests of consumers, and to challenge abuses of concentrated economic power in the U.S. and world economy.

<u>Background</u>

AAI will soon make available on its web-site a study of competitive issues raised by vertical re-integration in the electricity industry with emphasis on lessons learned from the last merger wave. Much of what I will say today draws from the regulatory and antitrust experience with 70 some-odd mergers and acquisitions from the mid- 1990s to 2002 as a source of insight into how the Commission should be identifying, analyzing, and remedying current competitive issues. It is imperative that the competitive implications of current transactions be appropriately identified and analyzed, and any problems remedied to ensure that competition and consumers are not harmed.

The number of 203 filings increased four-fold between 2002 and 2003 and more than two-fold between 2003 and 2004. Moreover, the potential magnitude of reintegration in the industry is high. Even if a dominant utility in a small, transmission-constrained market acquired a merchant generator with a 5 percent market share, the attendant increase in market concentration would be significant. To put numbers to this, if a dominant firm has a market share of 60%, and five remaining firms have share of 20 percent, 5 percent, 5 percent, and 5 percent, and 5 percent, respectively, concentration before an acquisition or merger would be 4,100 (a highly concentrated market). If the dominant firm acquires a competitor with a 5 percent market share, market concentration would increase by 600 points to 4,700.

With all of this in mind, I would like to briefly discuss two issues: (1) identifying and remedying competitive issues and (2) standards for competitive analysis. Acquisition of merchant generation by a public utility or transfers of unregulated generation assets to a regulated utility affiliate raise both horizontal and vertical competitive issues. As you know, horizontal competitive problems involve one level of production, while vertical problems involve more than one level of production, such as transmission inputs, delivered gas inputs, or generation inputs and wholesale electricity outputs.

Accurately Identifying and Remedying Competitive Problems

The Commission has accurately identified some vertical concerns in recent cases, such as the chilling of incentives for entry resulting from non-competitive input procurement. But there are numerous others, including discrimination, raising rivals' costs, input (or transmission) foreclosure, and customer (or generation) foreclosure, anticompetitive information sharing, and regulatory evasion. Many of these issues dominated the transactions of the 1990s, including the AEP/CSW and Ohio Edison/Centerior mergers, the Koch/Entergy joint venture, Pacific/Peabody Coal, Consumer's Energy/Panhandle, and Pacific/Enova.

It is important to accurately frame out the competitive issues in current transactions. Utility acquisitions of independent generators can change the incentive and ability to lessen competition through, for example, withholding generation to drive up price. Here, increases in market concentration can signal potential competitive harm. Vertical combinations can change incentives and ability to lessen competition through exclusionary conduct. Here, market competitiveness (in terms of the level of concentration, not changes in concentration) in upstream and downstream markets is indications of potential harm. In these cases, AAI would encourage the Commission to consider theories of competitive harm it put forward in several vertical merger cases such as AEP/CSW and Pacific/Enova, such as input (transmission) foreclosure, anticompetitive information sharing, and the chilling of entry incentives that such post-merger behavior might produce.

Transfers of generation from an unregulated affiliated generator to a regulated utility affiliate potentially raise vertical competitive issues. Here, AAI would encourage the Commission to evaluate the possibility of customer (generation) foreclosure, whereby rival generators can be foreclosed from access to utility buyers, for example, as a result of an unlevel process by which utilities "acquire" or transfer affiliated generation. We would also note the importance of identifying regulatory evasion problems resulting from a firm artificially inflating the prices of generation "inputs," passing them on to regulated consumers, and shifting profits from the regulated to the unregulated affiliate.

A look back at the merger experience indicates a broad array of remedies that target either "ability" (the mechanism for engaging in exclusionary conduct) or "incentive" (the profitability of engaging in exclusionary conduct) in vertical mergers. These remedies include generation divestiture in Pacific/Enova, prohibitions on anticompetitive information sharing to eliminate "ability" in Pacific/Enova; and transparent gas procurement process in Koch/Entergy. The Commission's transmission standards of conduct and interconnection standards are positive developments in reducing the potential for competitive problems. But when additional remedies are necessary, AAI would encourage the Commission to consider structural remedies (as opposed to behavioral fixes) for addressing competitive problems. These include transmission expansion, divestiture, and relinquishment of control over transmission. Remedies that improve structural market competitiveness reduce concentration, and ease entry are likely to be more effective than ongoing conduct-based remedies that require ongoing compliance and Commission oversight.

Where the Commission feels it is limited in its ability to impose structural remedies, AAI encourages cooperative efforts with states (which may be in a better position to impose certain structural remedies) in their merger review process. AAI would also encourage the Commission not to rely overly on the assumption that retail regulation will always police, detect, and constrain evasion of retail regulation, particularly when wholesale and retail markets are so intertwined. This is particularly important as states and utilities are pressured to address reliability issues by quickly obtaining supply to meet demand requirements. AAI also urges the Commission to objectively evaluate claims that transactions enhance reliability as a "defense" for potential anticompetitive effects. The DOJ/FTC *Guidelines* provide for a balanced approach for weighing efficiency gains (if reliability is argued to increase efficiency) against anticompetitive effects. Taking this out of the *Guidelines* context and placing relatively more weight on reliability, as envisioned by the joint task force's Black Out Report's "reliability impact" risks approval of transactions that could harm competition and consumers.

AAI Strongly Supports a *Guidelines* Approach to All Competition Analysis

Finally, AAI strongly supports the Commission's application of a *Guidelines*-type approach to dispositions of assets involving unaffiliated entities under Section 203. As I mentioned yesterday, adoption of a *Guidelines*-type approach to evaluating all competitive issues that arise in Section 205 and 203 transactions--as opposed to the many and varied screens and tests that are currently in place—would be a very positive step. AAI also encourages the Commission—within the parameters of a *Guidelines* approach—also to consider alternative approaches and procedures for assessing the likely competitive effects of current transactions. A look back at analysis filed by applicants in a number of Midwestern merger cases tells a disturbing story.

For example, a merger filing made in late 1999 estimated concentration in the Dayton Power & Light peak-period market to be about 1,300 HHI while a merger filing made in 2000 estimated concentration to be about 5,600 HHI. Likewise, a merger filing made in late 1997 estimated concentration in the Virginia Power peak-period market to be almost 6,800 HHI while a filing made two years later estimated concentration to be only about 2,000 HHI. These inconsistencies are likely accounted for--among other things--by varied data sources and methodological approaches. But a lot of the inconsistency stems from the use of different models by merger applicants.

One way for the Commission to improve consistency in merger analysis is to develop or adopt some form of standardized model that could be used as a check on what merger applicants provide or, in the alternative, be used by the Commission with applicant-provided information. Even better, given the apparent downside of applying structural models to electricity markets in general, AAI encourages the Commission to consider the use of simulation models, which may be better suited for evaluating competitive issues by directly assessing price and output outcomes under different scenarios. This could well improve the consistency, predictability, and credibility of Commission analysis.

Again, thank you for the opportunity to offer our comments today and I look forward to any questions by the Staff, Commissioners, panelists, and others.