

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Market-Based Rates for Public Utilities

| Docket No. RM04-7-000

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 authorizations for market-based rates for 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.

Background

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. The study looks to one of the best sources of insight into how the Commission should be identifying, analyzing, and remedying current competitive issues and problems that is the regulatory and antitrust experience in evaluating and remedying 70 some-odd mergers and acquisitions over the period 1995 through 2002. Much of what I will say today will reference the content of that study.

The 1990s were marked by a considerable amount of M&A activity, entry and expansion by large independent generators, and intra-corporate reorganization of regulated generation into unregulated affiliates. In the current transition--wherever it may lead--it is imperative that the competitive implications of transactions be appropriately identified, analyzed, and remedied to ensure that competition and consumers are not harmed and that the gains from industry reforms

to date are not jeopardized. The Commission has acknowledged that open access has not cured the vertical problem implicit in integrated ownership of transmission, generation, and distribution. Moreover, a look back at the merger experience indicates that entry into wholesale markets is not particularly easy. I would like to briefly discuss two issues: (1) identifying and remedying competitive issues and (2) standards for competitive analysis.

Accurately Identifying and Remedying Competitive Problems

The Commission may want to consider streamlining its current approach to identifying and evaluating competitive concerns in Section 205 transactions to instead focus on vertical and horizontal competitive concerns. This approach would consolidate the existing four-part test, since generation market power, transmission market power, barriers to entry, and affiliate abuse are all subsumed under horizontal and/or vertical analysis. Power purchases involving a regulated utility and *either* affiliated or unaffiliated unregulated generator(s) pose both horizontal and vertical issues. As you all know, horizontal issues relate to one level of production and typically harm consumers directly through higher prices. Vertical issues involve more than one level of production such as transmission or generation inputs and wholesale electricity outputs. Vertical issues often involve harm to competition *and* to consumers.

It is important to identify the full range of theories of competitive or consumer harm that could flow from the horizontal and vertical competitive issues related to market based rate authorizations. To be sure, the Commission has accurately identified some vertical concerns in recent cases, such the chilling of incentives for entry as a result of non-competitive input procurement. But there are numerous theories of competitive harm that could arise in the current cases, including discrimination, raising rivals' costs, foreclosure, anticompetitive information sharing, and regulatory evasion.

Many of the foregoing concerns arose in transaction of the 1990s. The current transactions could involve not only input (transmission) foreclosure which arose in the AEP/CSW and Ohio Edison/Centerior mergers, but also customer (generation) foreclosure. In the latter case, rival generators can be foreclosed from access to utility buyers, for example, as a result of an unlevel process by which utilities purchase power from affiliated or unaffiliated generators. There are also regulatory evasion problems, which could result from a utility artificially inflating purchased power prices, passing them on to regulated consumers, and shifting profits from the regulated to the unregulated affiliate. In evaluating regulatory evasion, AAI would encourage the Commission not to rely overly on a blanket assumption that retail regulation will always police, detect, and constrain evasion. This is particularly important as states and utilities are pressured to address reliability issues and quickly obtain supply to meet demand requirements. AAI also encourages the Commission to ensure through rigorous enforcement of its transmission codes of conduct and interconnection procedures.

Accurately classifying and identifying competitive issues that arise in market-based rate transactions is very important. One reason is that analytical approaches for evaluating horizontal issues are somewhat different than for evaluating vertical issues. Horizontal analysis typically assesses the effects on market structure of the loss of a competitor and increased market concentration. Vertical analysis assesses the structural competitiveness of markets in terms of the level (not the change in) of market concentration in upstream and downstream markets.

Remedies will also vary for vertical and horizontal competitive problems. A look back at the merger experience indicates that remedies for competitive problems generally target “ability” (the mechanism for exercising market power) or “incentive” (the profitability of exercising market power). A good remedy for a horizontal concern would not target “ability” through bid

caps but would reduce or eliminate “incentive” by requiring divestiture of generation or transmission expansion to increase the scope of the relevant market and reduce market concentration. For vertical problems, divestiture can reduce or eliminate “incentive,” as in the DOJ consent decree in the Pacific/Enova merger. But in some cases, it may be preferable to target “ability,” could include relinquishment of control over transmission or requirements for transparent input procurement processes in cases of regulatory evasion, as FTC did in the Koch/Entergy joint venture.

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

Finally, AAI would strongly encourage the Commission to reevaluate its analytical approach to assessing the competitive effects of market based rate transactions. The Commission employs widely different standards for competitive analysis across Sections 205/206 and 203 cases. These techniques include Appendix A, pivotal supplier, and seasonal market share tests. In contrast, antitrust employs a consistent set of techniques and methodologies to evaluate competitive concerns. Thus, AAI would strongly encourage the Commission to look to a DOJ/FTC *Guidelines* approach (both vertical and horizontal) for evaluating competitive concerns involving market based rate transactions. This approach includes defining and evaluating markets, assessing the ease of entry, and considering any countervailing efficiencies. AAI would also encourage the Commission to pursue nonstructural approaches such as the use of simulation models to directly estimate price and output effects resulting from a particular transaction. A *Guidelines* approach will ease controversy over such issues over market definition, the correct measure for assessing participation in the market, and time-differentiated product markets. This will promote a higher level of integrity and consistency in the Commission’s economic analysis.

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