

**BEFORE THE
UNITED STATES OF AMERICA
FEDERAL ENERGY REGULATORY COMMISSION**

Market-Based Rates for Public Utilities)

RM04-7-000

Comments of the American Antitrust Institute

The American Antitrust Institute (AAI) appreciates the opportunity to offer its comments in the Federal Energy Regulatory Commission’s rulemaking on Market-Based Rates in Docket No. RM07-4-000. The AAI is an independent Washington-based non-profit education, research, and advocacy organization. Our mission is to increase the role of competition, assure that competition works in the interests of consumers, and challenge abuses of concentrated economic power in the American and world economy.¹

INTRODUCTION

AAI’s comments are in response to a number of issues surrounding the generation market power “prong” of the Commission’s four-part approach to evaluating requests for Market-Based Rates (“MBRs”). In a previous statement presented by AAI Vice-president and Senior Research Fellow, Diana Moss, at the Commission’s June 9, 2004 technical conference,² AAI offered its views on competitive issues arising in conjunction with MBR review in Section 205 cases. We stressed the importance of: (1) accurately identifying both vertical and horizontal competitive issues; (2) considering structural remedies--as opposed behavioral fixes geared to policing firm conduct—when competitive concerns arise; and (3) adopting approaches to market definition and evaluation that are more in line with accepted legal-economic principles for competitive analysis.

¹ More information on AAI is available at <http://www.antitrustinstitute.org/about.cfm>.

² Those remarks are available at <http://www.antitrustinstitute.org/recent2/323a.pdf> and <http://www.antitrustinstitute.org/recent2/323b.pdf>.

The Commission has received voluminous input on its interim approach to evaluating request for MBRs. The controversial subject of generation market power has particularly attracted attention. The Commission is to be commended for its care and thoughtfulness in seeking out and soliciting different stakeholder views and expert opinion on MBR review. At the same time, however, a protracted cycle of conferences and comments increases the risk that the dialog will migrate farther afield of the important principles that should be at the core of competitive analysis. AAI believes, therefore, that the Commission should begin the process of winding down the discussion, focusing on objective and accepted legal-economic approaches to evaluating competitive issues, and considering the difficult issue of appropriate remedies for applicants that do not qualify for MBRs.

In the sections that follow, AAI will comment briefly on two topics: (1) the realities of MBR decisions and (2) problems with the two generation market power screens.

THE REALITIES OF MARKET BASED RATE DECISIONS

Market-based rate policy is one of the most important issues in restructuring U.S. electricity markets. It is in this context that AAI notes two facets of MBR review which make it very much a high stakes policy issue, emphasizing the importance of getting MBR decisions “right” in the first place.

The Commission is the “Cop on the Beat” When it Comes to Market Power

Deciding *how* a firm sets its prices brings into sharp focus the mixed model of regulation and competition that is the outcome of restructuring thus far. In this quasi-competitive model, elements of competition must coexist with regulatory oversight. In theory, as industries successfully restructure and competition gains the upper hand in the mixed model, antitrust should become a more viable and effective venue through which

competition is preserved. In electricity, however, it is clear that the mixed model is relatively permanent, making it more difficult for the competition laws to play an effective role.

Moreover, antitrust cannot, or will not, respond to some important market power concerns that arise in electricity. These factors together make the Commission the only effective “cop on the beat” when it comes to dealing with the harmful exercise of market power. There are two major areas of competitive concern in which antitrust plays a limited role.

First, the antitrust laws are not, by design, a venue for responding to a generator that unilaterally withholds generation to drive up price. This stands in contrast to responding to collusive conduct under Section 1 of the Sherman Act, or conduct that excludes competitors under Section 2 of the Sherman Act.³ Absent comprehensive restructuring of a monopoly firm, antitrust remedies for the single-firm conduct by a dominant generator if the sort witnessed in California would require ongoing monitoring of a firm’s pricing. The courts are not well-equipped for this job, but regulators are. Moreover, antitrust’s after-the-fact approach, usually involving very lengthy periods of time, is not well-suited to expeditiously addressing the harm associated with supracompetitive pricing.⁴

Second, antitrust has been relatively passive in responding to single-firm conduct that involves discriminating in the provision of transmission service or foreclosing rivals’ access to transmission. Exclusionary conduct of this sort would adversely affect competition in complementary generation markets, ultimately harming consumers through higher prices.

³ As Donald Turner noted in 1962:

“ . . .to hold unlawful the charging of a monopoly price by a monopolist, or the maintaining of noncompetitive prices by oligopolist, would be to invoke a purely public-utility interpretation of the Sherman Act. . .Congress did not intend the courts to act much like public-utility commissions in order to cure the ill effects of non-competitive oligopoly pricing.” Donald F. Turner, *The Definition of Agreement Under the Sherman Act: Conscious Parallelism and Refusal to Deal*, *Harvard Law Review* 75, 1962, p. 669.”

⁴ “Supracompetitive” and “anticompetitive” are used interchangeably.

But few major antitrust cases involving a transmission owner's refusal to deal with competitors emerged after *Otter Tail*. Moreover, findings of antitrust liability for refusals to deal in electricity could be troubled by the precedent set forth in the Supreme Court's 2004 decision in *Trinko*. In that case, Verizon was alleged to have refused to deal with competitor ATT in the latter's attempt to gain access to the incumbent monopolist's local telecommunications network.⁵ The Court's decision in *Trinko* not only failed to recognize the essential facilities doctrine, it articulated a very (if not completely) limited role for antitrust in an industry where open access (enabled by legislation) is implemented by a regulatory agency.

Limitations on the Commission's Ability to Redress Competitive Harm

Another reality of MBRs is that the Commission has limited ability to redress harm caused by a firm with MBR authority. FERC can technically revoke MBRs, but those decisions are not without consequences. Mixed markets in which some sellers can price in an unrestrained manner while others are subject to cost-based regulation will almost *always* be less preferable to markets that have undergone structural reforms and are therefore more conducive to competitive outcomes when firms can price in response to market dynamics.

Moreover, once MBRs are granted, the harmful exercise of market power may be difficult for the Commission to pursue. Under the Filed Rate Doctrine, for example, once a rate is filed and approved, it cannot be challenged except through noticed regulatory

⁵ See 540 U.S.____, 124 S.Ct. 872, 2004 WL 51011, 2004 Lexis 657, January 13, 2004. Gregory Werden, "Remarks at the American Antitrust Institute Fifth Annual Energy Roundtable Workshop, 'Open Access Revisited,'" January 11, 2005. Online. Available <http://www.antitrustinstitute.org/recent2/368.pdf>. Accessed January 29, 2005. See also, J. Bruce McDonald, "Antitrust Division Update: Trinko and Microsoft," Remarks before the Houston Bar Association, April 8, 2004, Online. Available <http://www.usdoj.gov/atr/public/speeches/204227.pdf>. Accessed January 30, 2005. Phillip Areeda, "Essential Facilities: An Epithet in Need of Limiting Principles," *Antitrust Law Journal* 58, 1989-1990, pp. 841-843 in which he discusses the limited nature of the Court's essential facility finding in *Otter Tail*.

proceedings.⁶ FERC and the courts have already recognized this interpretation as the doctrine applies to MBRs--one that stymies timely and effective regulatory response to anticompetitive behavior. Even if the Filed Rate Doctrine fails ultimately to apply to MBRs, FERC is further limited in its ability to deal expeditiously and effectively with the harmful exercise of market power by its civil penalty authority, nonpunitive fines, and retroactive refunds.

Implications

What all of this means is that once MBRs are granted: (1) FERC shoulders most of the enforcement burden in responding to the harmful exercise of market power and (2) has only very modest tools with which to deal with competitive and consumer harm. These two factors alone significantly raise the stakes on getting MBR decisions “right” in the first place. Here, the consequences of Type I (false alarm) and Type II (failed alarm) error are the most evident. Failing to grant MBRs to a firm that should have them ultimately deprives consumers from the efficiency-enhancing benefits of market pricing. Granting market-based rates to a firm with a dominant market position raises the specter of competitive and consumer harm.

The most important implication of the high stakes game of MBRs is the need for effective structural remedies. As AAI and other commenters have noted, competitive problems in electricity markets are best corrected by structural remedies such as generation

⁶ See, for example, *Attorney General's Energy White Paper: A Law Enforcement Perspective on the California Energy Crisis*, Attorney General Bill Lockyer, State of California, April 2004, p. 9. Online. Available <http://www.antitrustinstitute.org/recent2/370.pdf>. Accessed March 13, 2005; James R. Atwood, “Antitrust, Joint Ventures, and Electric Utility Restructuring: RTGs and POOLCOs,” *Antitrust Law Journal* 64(2), 1999, pp. 323-339; and Werden, *op. cit.*

divestiture or transmission expansion.⁷ Structural remedies have a number of well-known advantages. First, well-devised divestiture and transmission expansion conditions for MBR applicants failing the tests are likely to be one-time fixes to structural market imperfections. Since structural reforms are not designed to police firm conduct, the Commission avoids the intensive and costly market oversight and monitoring that has come to dominate restructuring electricity markets in the U.S. Second, market made less concentrated through structural reforms are more conducive to competitive outcomes, lessening the probability that some market participants have MBR authority while others do not. AAI thus encourages the Commission in problematic MBR cases to utilize effective structural remedies as much as possible.

THE GENERATION MARKET POWER TESTS

The Commission asks whether it should permanently retain two tests for generation market power: the pivotal supplier and wholesale market share analyses. As they stand, these analyses are not likely to produce particularly accurate results, further complicating the high stakes game of MBRs.

Pivotal Supplier Analysis

The pivotal supplier analysis compares an MBR applicant's capacity available to serve wholesale demand with the *aggregate* of capacity controlled by other suppliers in a market defined as the applicant's control area plus directly interconnected areas. If the applicant controls relatively more capacity than other suppliers, the implicit conclusion is that those suppliers *would not* discipline the applicants' supracompetitive pricing. An applicant would therefore fail the test. If the applicant controls less capacity, then the conclusion is that an

⁷ See, for example, Prepared Statement of Mark S. Hegedus on Behalf of American Public Power Association and Transmission Access Policy Study Group, Federal Energy Regulatory Commission, Docket No. RM04-7-000, January 27, 2005.

applicant's ability to raise prices to anticompetitive levels *is* effectively disciplined by other suppliers. The applicant would therefore pass the test. Given the construction of the pivotal supplier analysis in aggregating the capacity of all other suppliers in the market, it would not be surprising to find a low failure rate in all but the most transmission-constrained markets.

Viewed in the most favorable possible light, the pivotal supplier analysis could be a simplistic attempt to capture possible outcomes in oligopoly markets on the basis of a residual demand analysis. Such analysis—if performed correctly--would estimate the demand faced by an MBR applicant after it accounts for the expected behavior of its rivals. But the dynamics among firms in oligopoly markets are complex and outcomes depend on underlying assumptions about the instruments of competition (e.g., on price or quantity). None of this is reflected in the pivotal supplier analysis. Moreover, an accurate residual demand analysis would require far more complex methods (e.g., simulation models) than the accounting-type approach of the pivotal supplier analysis to draw useful conclusions about likely market outcomes.

In reality, the pivotal supplier analysis does little more than construct an unrealistic duopoly wholesale market consisting of the MBR applicant and the aggregate of all other suppliers. Moreover, the pass/fail criterion implies that that if the applicant has up to 49 percent of the market, then the firm could not price supracompetitively. This assumption contradicts accepted economic theory--overlooking the possibility that a duopoly with roughly equal-size firms would produce supracompetitive prices as a result of *coordinated interaction*. Thus, as easy as the pivotal supplier analysis is to implement, and as attractive is the pass/fail answer it provides, the cramped economics behind the test greatly limits its ability to accurately capture the potential for an MBR applicant to exercise market power.

AAI suggests that the test should not—at least in its current form—be part of a permanent and durable MBR policy.

Wholesale Market Share Analysis

The wholesale market share analysis considers the role of individual suppliers in the market by using market share, instead of the “who is bigger” criterion of the pivotal supplier analysis. This increases the failure rate on the test. The wholesale market share analysis also attempts to account for the product dimensions of electricity markets by looking at wholesale demand by season. AAI suggests a number of ways, however, in which the wholesale market share analysis could be improved to bring it more in line with accepted principles of competitive analysis.

First, the threshold criterion for concern over potential harm should be expanded to consider market concentration using the criteria for unconcentrated, moderately concentrated, and highly concentrated markets set forth in the U.S. Department of Justice and Federal Trade Commission *Horizontal Merger Guidelines* (“*Guidelines*”).⁸ High market shares reveal a dominant firm and a higher probability of supracompetitive pricing. But shares provide much less insight into how conducive the market is to anticompetitive outcomes resulting from coordination interaction. While the Commission’s hands have been full with unilateral conduct cases, the characteristics of electricity that increase the probability of coordination should not escape the Commission’s attention. Market concentration statistics are the best indicators of this concern, but the wholesale market share analysis does not use them. Given the imperative of getting MBR decisions right in the first place, MBR tests should screen for the potential for harm from unilateral and coordinated conduct.

⁸ U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines*, April 2, 1992.

Second, the wholesale market share analysis should be revised to consider what is at the core of market power—control over prices. As defined by the DOJ/FTC *Guidelines* (adopted by the Commission as the basis of its merger review), market power is “the ability to profitably maintain prices above competitive levels for a significant period of time.”⁹ Prices are a central focus of competitive analysis.¹⁰ The Commission itself uses prices to define relevant markets under its merger review guidelines set forth in the *Merger Policy Statement*. Numerous commenters have also pointed out the importance of using prices in MBR analysis.¹¹

Despite the accepted importance of prices in competitive analysis, nowhere do prices enter the Commission’s proposed wholesale market share (or pivotal supplier) analysis. Without prices, relevant markets cannot be accurately defined using the structural market models favored by the Commission.¹² This is because without a benchmark competitive price, it is impossible to determine what capacity (i.e., suppliers) consumers could turn to in order to avoid a price increase by a firm with MBR authority. And without knowing how much capacity could “discipline” such a price increase, it is impossible to determine whether the increase would be profitable—the question at the core of the market power question.

In sum, the supply and demand information on which the wholesale market share analysis is based is of extremely limited value without prices. AAI encourages the Commission to considering addressing this problem by defining electricity markets according to accepted legal-economic principles. AAI also encourages the Commission to

⁹ *Guidelines*, op. cit., § 0.1.

¹⁰ Prices are used in antitrust analysis, among other things: (1) as a metric for comparing outcomes under differently structured markets (e.g., in the Staples/Office Depot merger), (2) in estimating how much a firm prices above cost (the Lerner Index), and (3) to determine the extent to which consumer switching in response to a price increase will make such a price increase unprofitable (critical loss analysis).

¹¹ See, for example, Written Statement of Julia Frayer, London Economics International LLC, Federal Energy Regulatory Commission, Technical Conference re: Docket No. RM04-7-000, January 27, 2005.

¹² See also the discussion of market definition in: Comment of the Federal Trade Commission, Federal Energy Regulatory Commission, Market-Based Rates for Public Utilities, Docket No. RM04-7-000, July 16, 2004.

avoid pursuing EEI's proposed "historical contestable load analysis." This analysis misses the mark by ignoring the critical role of prices in market analysis, instead attempting to hone in on a "better" estimate of wholesale demand.¹³

A logical starting place for better market definition is the Commission's Delivered Price Test. Under that test, relevant product markets are determined through an analysis of time-variant demand—by season and time period (e.g., peak, off-peak, shoulder). The geographic scope of a relevant market is then established by identifying the capacity that can be supplied at, or less, than 5 percent above the market clearing price.¹⁴ Market shares and concentration based on such market definition will be more accurate than those that emerge from the wholesale market share analysis, improving accuracy and providing a basis upon which the Commission can make consistent and sound MBR decisions.

Implications

Given the high-stakes nature of MBR decisions, it is important that the Commission's tests for generation market power reflect sound legal-economic principles and accepted methods for evaluating the potential for competitive and consumer harm. Multiple tests can be useful, but only if their results are mutually reinforcing. The pivotal supplier and wholesale market share analyses are not likely to do this—at least in their current forms. Without an economic overhaul, the pivotal supplier test is of very limited value and unlikely to produce accurate results. The Commission may therefore want to consider modifying the wholesale market share analysis along the lines discussed above. Alternatively, the

¹³ Testimony of Louis R. Jahn, Edison Electric Institute, Federal Energy Regulatory Commission, Technical Conference re: Docket No. RM04-7-000, January 27, 2005.

¹⁴ AAI would argue that market shares and concentration should also be calculated for capacity with costs *near* the market price (i.e., marginal capacity), in addition to statistics for the total of inframarginal and marginal capacity. Marginal capacity is useful because it is the capacity that sets the market price and can potentially discipline a price increase.

Commission could adopt the Delivered Price Test as the primary analytic for evaluating generation market power.

Respectfully submitted,

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