VIA ELECTRONIC AND FIRST CLASS MAIL

September 19, 2007

Joseph Kelliher
Chairman
Federal Energy Regulatory Commission
888 1st Street, NE
Suite 11-A
Washington, D.C. 20426

RE: FPA SECTION 203 SUPPLEMENTAL POLICY STATEMENT (DOCKET NO. PL07-1-000) – COMMENTS ON APPENDIX A ISSUES

Dear Chairman Kelliher:

The American Antitrust Institute (AAI), together with the signatories below,[1] submits this letter to the Commission addressing the Appendix A discussion set forth in the Commission's *FPA Section 203 Supplemental Policy Statement* (*SPS*), issued on July 20, 2007.[2]

INTRODUCTION

The *SPS* discusses a number of issues relating to merger review under Section 203 of the Federal Power Act (FPA). These include: (1) blanket authorizations, (2) cross-subsidization, (3) "Competitive Screen Analysis" (i.e., Appendix A), and (4) disposition of control. The first two of these issues are the subject of separate Notices of Proposed Rulemaking (NOPRs).[3] The Commission has also sought input on most topics from experts and interested parties through technical conferences. However, the Commission has issued no NOPR regarding Appendix A. Instead, it has set forth its policies in its *SPS*, which provides no formal channel for the public or affected parties to comment.

[1] The views and opinions expressed herein are solely those of the signatories and do not necessarily reflect the positions of the signatories' employers or clients. Diana Moss, Vice President and Senior Fellow, AAI, conveys the views of the AAI. For background on the AAI, see www.antitrustinstitute.org.

[2] *FPA Section 203 Supplemental Policy Statement* ("*SPS*"), Docket No. PL07-1-000, 120 FERC ¶ 61,060 (issued July 20, 2007), 72 Fed. Reg. 42277 (August 2, 2007).

[3] Comments were due in the blanket authorization (Docket No. RM07-21-000) and cross-subsidization (Docket No. RM07-15-000) proceedings on September 6, 2007.

We believe the Commission's *SPS* discussing Appendix A rejects, without adequate justification, a number of concerns raised by panelists at the Commission's technical conference (Technical Conference) held on March 8, 2007. If left unaddressed, these problems—many of which reflect the consensus views of several merger policy experts—could indelibly and negatively affect the Commission's process of reviewing mergers of jurisdictional public utilities and therefore the ratepayers it is statutorily required to protect.

QUESTIONS RAISED BY THE SUPPLEMENTAL POLICY STATEMENT

To its credit, the Commission has indicated that it is open to changes to its Appendix A approach to evaluating mergers.[4] However, it is clear from the *SPS* and the discussion at the Technical Conference that the standard for any such changes is whether advocates can definitively demonstrate that the Commission has made wrong decisions in its application of current policies.[5] The use of this standard presents some cause for concern.

First, the Commission's stance is only defensible if it is unequivocally "right" on several important questions. As discussed below, this may not be the case. Second, the *SPS* does a disservice to the "consistent with the public interest" standard which Congress included in FPA Section 203. By requiring evidence that the current approach has produced an "Alamo," [6] the Commission ignores the fact that improvements to its approach may not necessarily have produced different outcomes but, rather, more effective remedies and analytical consistency across merger cases.

As electricity markets evolve, the Commission should attempt to improve the way it implements its policies and discharges its responsibilities. Changes in market conditions, institutions, technology, information availability, and incentives facing market participants all make the case for a flexible analytical approach. High-quality analysis provides the foundation for good decision-making that necessarily underlies the statutory "consistent with the public interest" standard. And while the Commission has demonstrated a good deal of analytic flexibility in other areas of its jurisdiction, this has not extended to merger review.

We can only encourage the Commission to pursue improvements to its analysis of mergers. But we can point to several issues in which the *SPS* falls short of providing a justification for maintaining the *status quo* approach. One is recent evidence that the Commission's merger analysis does not always go sufficiently beyond concentration statistics to render sound decisions. A second is the erroneous assumption that the Commission's reliance on Applicant-performed analysis is a fail-safe method for screening mergers.

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[4] Federal Energy Regulatory Commission, *In The Matter Of Technical Conference on the Commission's Merger and Acquisition Review Standards* ("*Technical Conference Transcript*"): Docket Nos. RM05-32 and RM05-34, March 8, 2007, at p. 176. The docket number for the technical conference is AD07-2-000 (Technical Conference on Public Utility Holding Company Act of 2005 and Federal Power Act Section 203 Issues).

[5] See, e.g., *Technical Conference Transcript* at p. 82 and pp. 175-177 and *SPS* at PP 68 (for discussion with regard to economic modeling).

[6] *Technical Conference Transcript* at p. 82.

FAILURE OF THE SUPPLEMENTAL POLICY STATEMENT TO JUSTIFY A "STATUS QUO" POLICY TOWARD APPENDIX A

1. Evidence That the Commission's Merger Analysis Does Not Always Go Sufficiently Beyond Concentration Statistics to Render Sound Decisions

Several participants at the Technical Conference made the point that implementation of the Competitive Screen Analysis stops prematurely at § 1 of the Department of Justice/Federal Trade Commission (DOJ/FTC) *Horizontal Merger Guidelines (Guidelines)*.[7] This step is defining markets and evaluating market concentration. We applaud the Commission for adhering to the *Guidelines* principle that a merger that increases concentration beyond certain limits is presumed to create adverse competitive effects.[8]

However, truncating the analysis at § 1 of the *Guidelines* has an important downside.[9] That is, without a well-articulated theory of competitive harm (i.e., analysis of potential adverse competitive effects) (*Guidelines* § 2), it is difficult, if not impossible, to craft an effective remedy that prevents anticompetitive effects while preserving demonstrated efficiencies that will benefit consumers.[10]

The *SPS* dismisses the concern that competitive effects analysis plays a relatively minor role in the Commission's merger analysis, stating that it focuses on the merged company's "ability and incentive" to exercise market power. We take "ability and incentive" to mean a theory of competitive harm (*SPS* at PP 65). The Commission cites to its reasoning in *Commonwealth Edison Co.*, *American Electric Power Company and Central and Southwest Corp.*, and the *Filing Requirements Rule* for support (*SPS* at PP 60-62 and 65).[11]

As a preliminary matter, we note the language cited from the *Filing Requirements Rule* does not pertain to competitive effects analysis. Rather, the language cited refers simply to an analysis of "market conditions," something very different than what goes into formulating a theory of competitive harm (*SPS* at PP 65). Moreover, the *SPS* cites cases that are almost

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[7] U.S. Department of Justice and Federal Trade Commission, *Horizontal Merger Guidelines ("Guidelines")*, 57 Fed. Reg. 41,552 (1992).

[8] This "structural presumption" can be rebutted by the merging parties. In general, there is a range of views as to how strong the presumption should be.

[9] A number of parties commented in the original rulemaking that produced Order. No. 592—the *Merger Policy Statement*. See, e.g., the Federal Trade Commission, Bureau of Economics at http://www.ftc.gov/be/v960008.shtm.

[10] An abbreviated analysis could also result in condemning a merger that triggers the *Guidelines* thresholds and would, therefore, be inconsistent with FERC's "consistent with the public interest" standard, despite a showing that there is no plausible theory of potential competitive harm with respect to that merger.

[11] *Commonwealth Edison Co.*, 91 FERC ¶ 61,036 (200), *American Electric Power Company and Central and Southwest Corp.*, 90 FERC ¶ 61,242 and 91 FERC ¶ 61,129 (2000), and the *Filing Requirements Rule*, FERC Stats and Regs. ¶ 31,111 (2000), 65 Fed. Reg. 70984 (November 28, 2000).

eight years old. A look at the Commission's decision in a more recent case--*Exelon/PSEG*--appears to show that HHI statistics were essentially the end of the road in the decision-making process.[12]

In *Exelon/PSEG,* the Commission states, for example:

> "We are not convinced by arguments that Applicants should have analyzed the merger's effect on their ability and incentive to harm competition by engaging in strategic bidding (which is a form of unilateral market power). The Commission's analysis focuses on a merger's effect on competitive conditions in the market. That is, we look at the merger's effect on the concentration of the relevant markets, as measured by the HHI. . .The Merger Guidelines recognize that the HHI does, in fact, convey information about the likelihood of the unilateral exercise of market power. (citing § 2.0 of the Merger Guidelines)." (*Exelon/PSEG* at PP 131)

and in regard to the remedy that:

> "Applicants' proposal to divest sufficient capacity to reduce market concentration to within the screening tolerance for increases from the pre-merger concentration level is one reasonable way to mitigate the merger-related harm to competition. [footnote omitted]" (*Exelon/PSEG* at PP 132)

But the antitrust agencies make a good case for moving beyond HHI statistics. The *Guidelines,* for example, say:

> "However, market share and concentration data provide *only the starting point* [emphasis added] for analyzing the competitive impact of a merger. Before determining whether to challenge a merger, the Agency also will assess the other market factors that pertain to competitive effects, as well as entry, efficiencies and failure." (*Guidelines* § 2.0 at p. 18)

And the DOJ *Antitrust Division Policy Guide to Merger Remedies* stresses the critical link between a theory of harm and remedy:

> "Before recommending a proposed remedy to an anticompetitive merger, the staff should satisfy itself that there is a close, logical nexus between the recommended remedy and the alleged violation — that the remedy fits the violation and flows from the theory of competitive harm."[13]

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[12] *Exelon Corporation and Public Service Enterprise Corporation, Inc.* ("*Exelon/PSEG*"), 112 FERC ¶ 61,011, July 1, 2005.

[13] U.S. Department of Justice, Antitrust Division, *Antitrust Division Policy Guide to Merger Remedies*, October 2004, pp. 3-4.

Indeed, the different approaches taken by the antitrust agencies and FERC have garnered equally different results. In *Exelon/PSEG*, for example, the DOJ articulated a clear and detailed theory of harm and negotiated a consent order that addressed adverse competitive effects with divestitures of specific generating assets to approved buyers. This remedy looks very different from the mitigation plan that FERC accepted from the merger Applicants at the time it approved the merger. That plan included divestiture of, and long-term contracts for, unspecified generating units to unknown buyers.

The importance of having an appropriate and relevant analysis of likely merger-related harms is greatest when those risks are mitigated while allowing the rest of the acquisition to proceed. This approach is common practice at both the Commission and antitrust agencies. In such contexts, lack of a clear understanding of probable adverse competitive effects of merger creates a substantial likelihood that relief will be misdirected and ineffective.

In light of this, we continue to be concerned that in recent years the Commission has not adequately examined the full complement of factors that go into sound merger review. Given the discussion of this issue in the *SPS*, however, we assume that in future merger cases, the Commission will in fact go well beyond market concentration statistics in conducting its merger analysis.

2. Evidence That the Commission's Reliance on Applicant-Performed Analysis is not a Fail-Safe Method for Screening Mergers

A number of participants at the Technical Conference suggested that the Commission's Appendix A analysis could be improved by developing alternative economic models. The *SPS* (at PP 66-74) rejects for a variety of reasons suggestions to expand its "toolkit" beyond exclusive reliance on Applicant-performed analysis. For example, the *SPS* asserts that concerns over the Commission's reliance on Applicant-performed analysis are misplaced since there are a variety of avenues through which problems can be raised and corrected. These include Commission-sanctioned amendments, supplements to filings, and the opportunity for intervenors to raise issues (*SPS* at PP 71).

Without doubt, many questions and problems can be vetted by scrutinizing Applicant-performed analysis. However, the Commission's reasoning that this process provides a fail-safe method for screening mergers is flawed for two reasons. First, for exclusive reliance on Applicant-performed analysis to be even remotely fail-safe, it has to be obtained at the expense of limiting the scope and flexibility of what analysis can be performed. The *SPS* appears to require that limited flexibility in stating:

> "Studies which do not conform to the Commission's *explicit* [emphasis added] requirements are either rejected or required to be revised until they do conform. . ." (*SPS* at PP 71)

But the *Merger Policy Statement (MPS)*[14] does not intend Appendix A to be applied in a rigid, lockstep fashion. [15] Rather, it demonstrates a good deal of flexibility and openness to the introduction of alternative methods or changes in analysis:

> "We also note that the screen is intended to be somewhat flexible. It sets out a general method, but we will consider other methods and factors where applicants properly support them." (*MPS* at 31,119) and "The Commission understands that the screen analysis described in the policy statement will evolve with industry restructuring and market maturation." (*MPS* at 30,135) and "The means of our analyses may also change." (*MPS* at 30,136)

Second, there are demonstrated, glaring inconsistencies in Applicant-performed analysis across merger cases.[16] The Commission's internal use of economic models to corroborate findings could well reduce the possibility of Type I and Type II error (e.g., failing unproblematic mergers and passing problematic mergers, respectively). The risk of committing such errors is heightened by applying an inflexible analytical screen when market conditions, institutions, and incentives facing market participants are in flux. Moreover, even though participants in the Technical Conference suggested that the Commission consider *various* types of economic models (e.g., structural and regional), the *SPS* appears to reject all forms of modeling on the basis of arguments against simulation models, in particular.[17]

Thus, the *SPS* presents a paradox. It rejects suggestions for change, effectively stating that the current approach is fail-safe. But it achieves that outcome in the face of contrary evidence and an increasingly rigid application of what was originally intended to be a more flexible screening approach. This approach is unlikely to lead to sound decision-making and produce outcomes that are "consistent with the public interest."

Implementing new analytic tools in any public policy venue is difficult and controversial. This is particularly true of the Commission's merger review, which must be structured to convey transparency and predictability to both the merging parties and affected market participants in an open, advocacy-based process. The Commission is to be commended for its willingness to hear about both the pros and cons of its Appendix A methodology. However, we respectfully submit that the *SPS* has--almost completely and with little justification--sidestepped the issue, to the potential detriment of competition and consumers.

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[14] *Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement* (*"MPS"*), Order No. 592, 61 FR 68595 (Dec. 30, 1996), FERC Stats. & Regs. ¶ 31,044 (1996).

[15] For a discussion of FERC's analysis of horizontal and vertical mergers, see, e.g., presentations by Darren Bush, Richard Gilbert, and Diana Moss at American Antitrust Institute, *AAI's 7th Annual Energy Roundtable Workshop: Agenda, Report, and Presentations ("AAI 7th ERW")*, April 4, 2007. Online. Available http://www.antitrustinstitute.org/Archives/7th_ERW_agenda.ashx.

[16] See, *AAI 7th ERW*, presentation by Diana Moss.

[17] Structural models are not the same as simulation models. The former define the scope of relevant markets and use metrics such as market share and concentration to make inferences about how conducive markets are to competitive outcomes. Simulation models, on the other hand, attempt to model market outcomes (e.g., price and quantity) directly under different conjectural scenarios about rival firm conduct. The purposes of, costs of developing, and data requirements for various modeling approaches are different.

CONCLUSION

We appreciate the Commission's consideration of the views expressed in this letter as it implements the *SPS* in particular merger dockets. If you have any questions regarding this letter or the issues covered in it, please feel free to contact us.

Sincerely,

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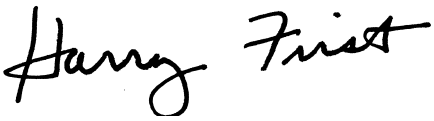

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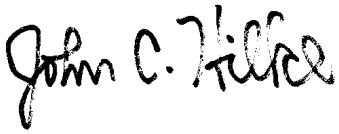

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cc:

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