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American Antitrust Institute 4th Annual Energy Roundtable Workshop

“The Evolving Role of Competition in Electricity Restructuring”

January 21, 2004

Summary of Proceedings

Introduction

On January 21, 2004, the American Antitrust Institute (AAI) held a day-long workshop on electricity restructuring issues at the headquarters of the National Rural Electric Cooperative Association (NRECA) in Arlington, Virginia.¹ The workshop was by invitation only. AAI greatly appreciates the participation of about 35 government officials, academics, consumer and business representatives. We are grateful to those who made presentations, asked questions or made comments in the workshop, and took the time to provide feedback after the event.

This was AAI's fourth annual workshop on electricity and competition policy.² Diana Moss, AAI Vice President and Senior Research Fellow³ developed the workshop agenda, presided over the discussion, and prepared the following observations about the proceedings. The proceedings themselves were off the record and not transcribed. Prepared presentations are attached to this document by permission of their authors, as well as the workshop agenda.

¹ AAI appreciates NRECA's valuable assistance in making the workshop possible.

² A summary of the 3rd annual roundtable workshop may be found at <http://www.antitrustinstitute.org/recent2/166.cfm>.

³ Dr. Moss was formerly Senior Economist and Coordinator for Competition Analysis in the Office of Markets, Tariffs, and Rate at FERC. She is also Adjunct Professor in the Georgetown University Public Policy Institute.

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The following observations represent only one participant's perspective on the more important themes to emerge from the presentation and discussion.

Proceedings

Speakers: Speaker presentations marked with a * are available on the AAI website: <http://www.antitrustinstitute.org>

1. **Glenn English, CEO, National Rural Electric Cooperative Association**
2. **Daniel Larcamp, Director, Office of Markets, Tariffs and Rates, Federal Energy Regulatory Commission**
- 3.* **David DeRamus, Partner and Vice President, Bates White LLC**
- 4.* **Michael Wroblewski, Assistant General Counsel, Policy Studies, Federal Trade Commission**
5. **William Massey, Former Commissioner, Federal Energy Regulatory Commission**
- 6.* **David Cook, Vice President and General Counsel, North American Electric Reliability Council**
7. **Alan Spen, Managing Director, Fitch Ratings, Global Power Group**
- 8.* **Lynn Hargis, Public Citizen, Critical Mass Energy and Environment Program**

General Observations

The purpose of AAI's fourth roundtable workshop on electricity restructuring was to bring together various stakeholders and perspectives on the new realities of restructuring in the U.S. electricity industry. In 2000, the roundtable theme was antitrust priorities. In 2001, the focus was on market monitoring, which was looking like a "catch as catch can" interpolation of antitrust and regulation--with few patterns and few successes. In 2003, the theme was transitional problems in electricity restructuring, which fostered a growing concern that the restructuring process is rough-going and that even partial mid-course reversals would be difficult (e.g., "You can't put the toothpaste back into the tube").

In 2004, the workshop discussion centered on the increasing intractability of problems underlying restructuring—political barriers involving the state/federal issues, lack of national

consensus on market and reliability issues, disarray in approaches for identifying and remedying the abuse of market power, lack of progress on RTO formation, vertical re-integration, the forces potentially unleashed by PUHCA repeal, and the difficulty of working a reliability mandate into a competition policy agenda. This year's discussion appeared to reflect both more intense concern over restructuring issues than in years past *and* more consensus on fundamental issues among the diverse stakeholders. Thus, while the differing perspectives and interests of individual stakeholders remain, there appeared to be a rallying around the importance of identifying and grappling with the larger policy issues.

For example, given the imperfections that are more the rule than the exception in U.S. electricity markets, some now question the sense in adhering to a competitive model as the central focus of restructuring ideology. The importance of stability in pursuing the course of restructuring now takes higher precedence. With the acknowledged parochial interests of states and change-resistant nature of investor-owned utilities and state regulatory commissions, it is clear that initiatives must come from FERC. But because of the many tensions underlying and impediments to restructuring, FERC experiences considerable frustration on major policy issues that should drive the debate. These issues include continued state/federal tensions on transmission siting, standard market design, RTOs, merger conditions, and vertical reintegration. Moreover, the Supreme Court's recent decision regarding access issues in the *Trinko* local telecommunication case may have potentially negative implications for antitrust enforcement in electricity.

Reliability issues were a major focus of the day's discussion, particularly since the failed Energy Bill contained provisions necessary to move the restructuring policy agenda forward.

Diana Moss recently authored a paper on competition and reliability in electricity, which holds out the prospect of a “paradigm shift” in the role of competition in restructuring.⁴ This shift is the third in a series over the last decade and poses perhaps the most difficult policy issues yet. These include conflicting economic incentives posed by competition versus reliability and the difficulty of implementing market oversight in concert with command-and-control reliability regulation.

The roundtable discussion revealed differences of opinion on whether reliability can be integrated into a competition policy agenda. But most acknowledge the lack of a national consensus on reliability and a resurgence of reliability issues in vertical competitive problems in the industry. A trend toward vertical re-integration in the industry--driven in part by reliability concerns--has created something of a paradox since a positive and workable role for competition may be possible only through structural reform (e.g., vertical separation). Policy makers are thus being forced to make a choice of priorities.

In all, there is a distinct sense that the industry is at a crucial cross-roads; that coherent policy direction and difficult choices will be necessary to bring some order to the disarray that currently prevails; and that (because FERC faces multiple challenges), much of the impetus for change and direction may have to come from outside the agency.

Themes in the Roundtable Discussion

Several themes in the restructuring debate emerged during the course of the roundtable.

- 1. Changes in the restructuring environment may foster vertical reintegration--careful assessment of old and new competitive issues is important**

⁴ Forthcoming in the *Electricity Journal*.

Many merchant generators are in distress--adversely affected by higher fuel-price, regulatory, and competitive risk.⁵ As a result, there is ongoing “rebundling” of generation, transmission, and distribution--largely by the vertically integrated incumbents who enjoy a favorable bargaining position in purchasing bankrupt assets. Reintegration may be fostered by a changed restructuring environment that places less emphasis on competitive markets, more weight on risk aversion, and which continues to grapple with institutional and legal problems that create a bias toward vertical integration.⁶

A longer-term trend toward vertical reintegration cautions care in assessing access issues in electricity—both old and new (e.g., anticompetitive affiliate transactions, the combination of generation and distribution, and transmission funding as a potential barrier to entry, and getting transmission access prices right). Reintegration at this stage could also be exacerbated by PUHCA repeal, which could encourage more--and more complex--business combinations that are outside the body of existing M&A experience. If PUHCA is repealed, many question whether state regulation can adequately deal with such mergers, the ability of regulation to proxy for PUHCA protections, and whether non-conventional owners (e.g., financial investors) can efficiently and reliably manage and operate electricity assets.

2. Comprehensively identifying the potential for and abuse of market power in electricity is a daunting task--some order should be brought to the process

M&A, market based rate proceedings, and allegations of discriminatory conduct all require identifying and remedying the abuse of market power. Competitive issues in electricity

⁵ Fuel price risk has increased due to higher natural gas prices. Competitive risk is higher due to actual or the threat of refusals to deal or discrimination problems involving merchant access to the grid.

⁶ Such problems include the inability of federal regulation to compel the construction of generation, which could promote entry.

involve more than just generation, which has been a primary focus to date. Most believe, however, that more attention should be given to how transmission, distribution, and generation can be used anticompetitively *and* the types of exclusionary conduct that could achieve such ends.⁷ It will be important to stay ahead of the curve when it comes to identifying who controls generation, which is becoming increasingly more difficult because of complex ownership and contractual arrangements. There also appear to be multiple paths that could be followed in dealing with market-based rate cases. These include the development of (1) more accurate but administrable screens for market power, (2) multiple screens that measure different things (e.g., unilateral and coordinated exercise) in different ways (e.g., structural versus simulation models) and/or (3) better mitigation.

3. The effectiveness of market power remedies is critical--structural fixes may be the only candidates that fit the bill

In light of continuing market power issues in the industry, the inherent limitations of forced access, and compliance problems, there appears now to be a consensus on the need for *effective* remedies, preferably structural in nature. Most are skeptical that RTOs—as close to a structural remedy that has ever been tried in industry restructuring—can effectively address vertical competitive problems. Moreover, when interim measures are imposed in merger cases, they should be effective before the transaction is allowed to close. But difficult policy issues remain, such as how to pursue structural remedies in light of political resistance and unclear statutory authority. These impediments could place more emphasis on the use of conditional approvals in FERC proceedings.

⁷ For example, leveraging monopoly into complementary markets, evading regulation, raising rivals' costs, or foreclosing competitors by refusing to deal, exclusive dealing, or discriminatory access.

4. Reliability poses multiple policy challenges and divided views—consensus is important in order to move forward

Reliability problems raise a number of difficult issues—many of which generate a good deal of consensus while others still produce divided views. Most—if not all—believe that reliability problems need to be addressed quickly, perhaps through standalone legislation absent the passage of a comprehensive Energy Bill. Many are of the view that competition does not produce the incentives necessary to ensure reliability (e.g., less price volatility, construction of generation and transmission when and where it is needed). On the other hand, competitive forces could produce multiple sources of demand reduction such as distributed generation and merchant generation and transmission. But further assessment and resolution of a number of key issues is necessary to move forward. These include: (1) the viability of generation-based reliability solutions;⁸ (2) implementation issues regarding demand-side response; and (3) how much and what types of transmission infrastructure is needed.

Concerns that reliability-enhancing attributes of potentially anticompetitive transactions may ill surface as efficiency defenses in merger and conduct cases are increasing. The consolidation of end-to-end transmission systems and of non-simultaneous peaking utilities are possibilities. Antitrust will address the viability such defenses in Section 4 of the *Guidelines*. However, FERC might have more flexibility to deal with reliability claims or concerns under the Federal Power Act. This raises key questions relating to (1) the possibility of an additional merger review factor (e.g., Commonwealth Factor) under the “public interest” standard of Section 203 and (2) whether the “just and reasonable” standard under Sections 205 and 206 can be construed to mean rates that foster reliability.

5. Wall Street's views have changed significantly in a short period of time—management, governance, and liquidity will be the focus into the foreseeable future

A change in Wall Street's view of industry restructuring has paralleled the rise and fall of the merchants. Preferences for a minimal federal role in the mid 1990s have been supplanted with a current demand for a stronger federal policy and a focus on management, governance, and liquidity. The financial model of today (driven by the successes of unregulated utility affiliates), is to *avoid* losing money whereas the model of yesterday (driven by the merchants) was making money. A utility's ability to maintain greater control over its own generation and transmission sources, rather than overly relying on outside energy providers, is also viewed more positively in the current market environment.

6. The Supreme Court's recent decision in the *Trinko* telecommunications case could have potentially negative implications for antitrust enforcement in electricity

The Supreme Court recently decided in the *Trinko* case that antitrust enforcement contributed little to the prosecution of discriminatory access claims under Section 2 of the Sherman Act when regulatory enforcement (i.e., 1996 Telecommunications Act) was available. Among other things, the decision has significant implications for the validity of the essential facilities doctrine and antitrust enforcement of refusal to deal claims in regulated network industries. Whether the decision sets a troublesome precedent that could influence antitrust enforcement in electricity remains to be seen. However, given the current state of tension and disarray in electricity restructuring, such a development could have distinctly negative implications.

⁸ As an alternative to transmission fixes that are impaired by state/federal tensions (e.g., regarding siting).