Summary of Proceedings[1]

Introduction

The American Antitrust Institute (AAI) held its 9th annual Energy Roundtable on March 3, 2009 at the headquarters of the National Rural Electric Cooperative (NREC) in Arlington, Virginia. AAI appreciates the generous assistance and sponsorship of NRECA and the American Public Power Association (APPA) in making the Roundtable possible. More than 40 people--from government, academia, consulting groups, consumer advocacy groups, trade associations and industry--participated in the workshop and engaged in a lively exchange of ideas and perspectives. AAI Vice President Diana Moss developed the agenda and presided over the discussion. The roundtable discussions that followed the panelists' presentations were off the record and not transcribed. This report briefly summarizes most of the presentations and accompanying discussion, without attribution to individual contributors. The following speakers made presentations:[2]

*__David Mohre__, Executive Director, Energy & Power Division, NRECA, *The Year in Review*

*__Joseph E. Fontana__, Transaction Advisory Services Global Utilities Leader, Ernst & Young LLP, *Competitive Implications of Private Equity Investment in the Electricity Sector*

*__Eric Emch__, Economist, U.S. Dept. of Justice, *Antitrust Approaches to Partial Equity Investments*

Nancy Bagot, Vice President Regulatory Affairs, Electric Power Supply Ass'n.

*__Peter Fox-Penner__, Principal and Chairman Emeritus, The Brattle Group, *Keynote Address*

*__Susan Kelly__, Vice President of Policy Analysis and General Counsel, American Public Power Ass'n, *APPA's Competitive Market Plan: A Reform Proposal*

*__Mathew W. White__, Professor, The Wharton School, Univ. of Penn., *Market Design in Electricity Markets*

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[1] The summary of proceedings was prepared by Richard Brunell, Director of Legal Advocacy, AAI, and Diana Moss, Vice President, AAI.

[2] An asterisk indicates that the presentation is available on AAI's website, www.antitrustinstitute.org, by permission of the authors.

***Mark Hegedus**, Attorney, Federal Trade Comm'n, *Market Design: Some Relevant Antitrust Fundamentals*

Overview

The purpose of AAI's annual Energy Roundtable is to bring together various stakeholders and perspectives to discuss issues relating to competition and regulation in electricity markets. This year's workshop focused on two issues: (1) the competitive implications of private equity investments in the electricity sector and (2) current issues involving electricity market design.

Highlights of the Presentations

I. Year in Review

A. Presentation

David Mohre presented the annual "year in review." He focused primarily on current trends in the industry and expected industry drivers in the next year, including the economy, the credit crisis, expected legislative initiatives, regulatory initiatives, and "conditions on the ground." He noted the enormous capital needs of the industry (particularly in light of current legislative initiatives) and emphasized the difficulty of financing new power projects in the current economic environment without long-term power supply contracts. Mohre raised the question whether the short-term focus of current centralized market designs will permit the industry to raise sufficient long-term capital.

B. Discussion

A commenter suggested that the decline in physical sales in the wholesale market in 3Q 2008 might partially reflect reduced trading by affiliates of financial institutions. Another noted that borrowing costs are lower now for regulated utilities as compared to unregulated merchant firms. However, it was noted that it would still be difficult today to consummate a merchant transaction without a long-term contract. Another commenter suggested that confidence in regional electricity market structures is the major factor in restarting capital flows, which does not necessarily require long-term contracts.

II. Morning Panel: Private Equity

A. Presentations

Joe Fontana, addressed trends in private equity investments in the electric power sector. He noted that there is currently very little M&A in general, including in the electricity sector. However, until the recent credit crunch, private equity had been an important part of electricity M&A activity since the late 1990s when private equity firms acquired divested assets in connection with horizontal mergers. He described three types of private equity investments: venture capital, leveraged buyouts, and infrastructure funds, with the latter two being most important. Private equity/LBO firms find the electric utility industry attractive

because of steady cash flows and heavy capital investment, which can support significant leverage, and if successful lead to returns of 20-25% of assets ("carried interest") when sold. While the traditional LBO model came under extreme pressure in 2008, some deals were done, albeit with less debt than before.

Nancy Bagot discussed a potential threat to a utility or merchant generator's market-based rate authority. Namely, a partial acquisition by a private equity firm with interests in other generation assets may result in those interests imputed to the utility or merchant at issue. The Electric Power Supply Association (EPSA) filed a petition with FERC seeking a bright-line rule under which an acquirer of less than a 20% ownership interest in a utility that files an attestation under SEC Schedule 13(g) that the acquisition is not for the purpose of exercising control would be deemed not to acquire control for purposes of § 203 of the Federal Power Act. One particular difficulty for acquirees, Bagot explained, is that the utility may not even be aware of the acquirer's other investment interests. FERC received several rounds of comments and held a workshop on EPSA's proposal in Fall 2008.

Eric Emch explained DOJ's approach to partial equity investments in direct horizontal competitors. Partial equity investments--with or without control interests--raise the risk of "unilateral effects" because some of the lost profits from raising prices are returned to the acquiring firm via its partial ownership interest. Partial equity investments may facilitate "coordinated effects" by reducing the obstacles to collusion (e.g., monitoring, punishment and reaching terms of agreement). Any interlocking financial stake may also increase the payoffs from cooperation. Emch pointed out that in two recent cases challenged by the antitrust agencies, the DOJ seemed to take a tougher line by requiring complete divestiture of the competitively overlapping assets, while the FTC only required removal of the control elements (i.e., passive investment was permitted).

B. Discussion

One commenter raised the question of whether there could be such a thing as a purely passive investment, particularly in a capital-constrained environment, where management of the acquiree would have some interest in pulling its competitive punches to please its investor. Moreover, the access to competitively sensitive information that passive investment normally entails may facilitate collusion. On the other hand, another participant suggested that management would be breaching its fiduciary duty to favor its investor by restraining competition against the investor's other interests. Another commenter responded that cooperation was usually in the interest of both competitors.

A key point of discussion centered on who should have the burden of establishing the investor's control or lack thereof. Some thought that the need to obtain up to $2 trillion investment in an industry starved for capital suggested that constraints on private equity investments should be minimized. Others thought that competition should not be sacrificed because of immediate exigencies, particularly for a product that is an essential service. One participant asked whether regulatory mitigation may be sufficient to prevent unilateral or collusive effects of partial ownership.

III. Luncheon Address

Peter Fox Penner provided a "big picture" perspective on the state of electric markets today. He noted that with respect to bulk power markets, the U.S. is gradually converging on an electric industry structure with common features. These include: (1) open access transmission, (2) vertical integration through ownership and long-term contracting, (3) centralized regional least-cost commitment and dispatch with day ahead and real-time spot markets (which work well if well regulated and not too large), (4) time-differentiated retail pricing, and (5) two- or three-part wholesale markets. He noted that retail choice for small customers is being replaced by *de facto or de jure* regulation. The principal policy imperatives facing the industry have changed from promoting electric competition as an end in itself to making a greener and cleaner power system with greenhouse gas controls soon to be adopted, reducing dependence on foreign oil (and the use of electricity to fuel our cars), and realizing the potential of the "Smart Grid."

Fox-Penner noted that the relationship between new policy imperatives and competition is symbiotic. For example, expansion of the grid to meet green power objectives will serve the goal of competition; investment in renewable energy will bring new players into power markets; demand response will enable markets that naturally attenuate market power; and smart grid technologies may enable retail choice benefits large enough to attract a critical mass of customers willing to pay for them. On the other hand, other factors suggest a mixed picture for the future of competition in the transition to the "New Energy Economy." Every role markets play will be challenged and critical.

IV. Afternoon Panel: Market Design Issues

A. Presentations

Susan Kelly outlined APPA's recently released *Competitive Market Plan*, which recommends that the day ahead and real-time spot markets in RTO regions be trimmed back in favor of an "optimization" market under which generators would be required to bid in their supplies based on actual short-run marginal costs, and that locational capacity markets be phased out in favor of load-serving entitiy (LSE) resource portfolio requirements. Long term Financial Transmission Rights (FTRs) would be allocated in accord with approved LSE supply resource plans, and transmission would be planned to support long-term power supply arrangements. APPA is not recommending this approach for regions where bilateral (non-RTO) markets operate.

Matthew White presented the results of a study that examined the effects of PJM's expansion into Ohio, Indiana, and Illinois in October 2004. As a result of the expansion, the volume of trade between the two regions tripled overnight, and the price spreads between the regions dropped significantly, suggesting an annual efficiency gain of $180 million annually. Output increased at lower cost (coal-fired) plants in the Midwest, while decreasing at higher cost (gas-fired) units in Maryland and New Jersey. White attributed the dramatic savings to the expansion of PJM's locational marginal pricing system, which allocates capacity based on congestion costs, to an area that had been operating under the OASIS bilateral pricing system, where capacity is allocated on a first-come first-served basis.

Mark Hegedus explained that the FTC supports regulatory reform that brings structurally competitive markets. The agencyhas been skeptical of behavioral remedies that seek to mitigate the exercise of market power. The FTC has also been very supportive of developing demand response resources as a means of empowering consumers and lessening the need for market power mitigation. Indeed, absent effective demand response, the ability to exercise market power in generation markets is high.

B. Discussion

The discussion focused on the need to fix the current system of allocating of FTRs which arguably blunts the effectiveness of locational marginal pricing and deters new entry. Also, while some pointed to the efficiency of consumers facing real price signals, one commenter noted transitional and equity problems when consumers do not yet have the ability to reduce demand. With respect to the PJM expansion, it was noted that the states with cheaper power were opposed because they expected price increases. There was a discussion of the relationship between short-term prices and investment in new power plants, with some suggesting that investment is governed by long-term price signals and average prices over time. In other words, marginal cost pricing in spot markets would not necessarily impact investment decisions.

One commenter suggested that FERC develop best practices for RTO market monitoring and market power mitigation, rather than have a different protocol in each RTO. Moreover, it was suggested that the information held by market monitors should be used in analyzing market power issues in mergers, and that the pivotal supplier test was critical in merger review.