Contact: Diana Moss
Phone: 720-233-5971
e-mail: dmoss@antitrustinstitute.org

American Antitrust Institute
6th Annual Energy Roundtable Workshop

"The Future of Electricity Competition"

January 24, 2006

Summary of Proceedings

Introduction

On January 24, 2006, the American Antitrust Institute (AAI) held a day-long roundtable workshop on electricity restructuring at the headquarters of the National Rural Electric Cooperative Association (NRECA) in Arlington, Virginia. The AAI appreciates NRECA's generous assistance in making the roundtable workshop possible.

This was AAI's sixth annual workshop on electricity restructuring and by invitation only.[1] The AAI appreciates the participation of about 40 government officials, academics, consultants, consumer advocates, and trade association and industry 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.

Diana Moss, AAI Vice President and Senior Research Fellow developed the workshop agenda, presided over the discussion, and prepared the following observations about the proceedings. [2] The proceedings themselves were off the record and not transcribed. Prepared presentations are available on the AAI web-site,

---

[1] A summary of prior annual roundtable workshop proceedings may be found in the archives at http://www.antitrustinstitute.org.

www.antitrustinstitute.org, by permission of their authors, as well as the workshop agenda. The following observations represent only one participant's perspective on the more important themes to emerge from the presentation and discussion.

Speakers and Presentations

Speakers: Speaker presentations marked with an asterisk are available on the AAI website: http://www.antitrustinstitute.org

1. Joseph Nipper--Senior Vice President, Government Relations, American Public Power Association American Public Power Association
2. Charles Gray--Executive Director, National Association of Regulatory Utility Commissioners
3.* David Mohre--Executive Director, Energy & Power Division, National Rural Electric Cooperative Association
4.* Michael Wroblewski--Assistant General Counsel, Policy Studies, Federal Trade Commission
5. Joseph Kelliher--Chairman, Federal Energy Regulatory Commission
6.* Hon. Richard Cudahy--Senior Judge, United States Court of Appeals, Seventh Circuit
7.* John Kwoka--Neal F. Finnegan Professor of Economics, Northeastern University
8.* Thomas Lenard--Senior Fellow, Vice President for Research, Progress and Freedom Foundation

General Observations

The purpose of AAI's annual energy roundtable workshops is to bring together various stakeholders and perspectives to discuss issues relating to electricity restructuring and competition. The 2006 workshop focused on the future of electricity competition, including key factors that influence competition and the elements of an effective forward-

[2] 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 and University of Colorado, Department of Economics.

looking policy.[3] In 2005, the energy roundtable discussion revealed a high level of concern over transmission and market power problems after 10 years of open access. In 2003 and 2004, the workshop discussions centered on major transitional problems in restructuring, the 2001 meeting highlighted market monitoring, and in 2000, the focus was on antitrust priorities.

Much like the 2005 workshop, the discussion this year revealed growing concerns about the path of restructuring, unresolved or intractable issues that are impeding further progress and what increasingly is considered a mismatch between the "model" of restructuring and the reality of the industry. A number of themes emerged that reflected both previously identified and new concerns.

<u>Themes in the Roundtable Discussion</u>

1. Cost/benefit analyses reveal few benefits from competition and significant diversity among studies that may be hard to reconcile

The discussion was informed by reviews of recent studies on the costs and benefits of competition in electricity, including those conducted by the New England ISO, Carnegie Mellon University, LeHigh Cement, and the Electric Power Supply Association. The dim view of the benefits of competition conveyed by many of the studies is troubling. Cost/benefit analyses are becoming particularly important to the substance and direction of restructuring. Pursuant to its charge under the 2005 Energy Bill, for example, the Interagency Task Force will need to determine if structuring is providing net benefits and

[3] Although many of the same individuals have attended most of our roundtables, about one-quarter of the attendees in 2006 had not participated in 2005.

choice to consumers. But this may be difficult to do on the basis of the current set of cost/benefit analyses.

Chief among concerns is that the studies contain different analytical frameworks and produce different estimates of costs and benefits, so some criteria for reconciling them are needed. Some studies could also be considered flawed or insufficient. For example, few studies consider the actual or potential problem of tacit collusion in electricity markets.

2. Current market conditions are particularly troubling and are creating incentives to move away from market mechanisms.

Workshop participants produced a long list of current problems in electricity markets. These include increases in natural gas prices and increased fuel price volatility; failure of natural gas capacity to fully “participate” in the market; increases in congestion costs and reliability problems; increases in electricity prices and impending removal of retail price caps; the failure of benefits from generation costs differentials to materialize; a decrease in the number of independent power producers; and high concentration in many regional markets. Also troubling is that most trading activity is occurring in the spot markets (e.g., around 40%), as opposed to in long-term contracts.

These problems have become evident in a number of different ways. One is an increase in the volume of consumer complaints—particularly among large industrials. Another is a return to integrated resource planning at the utility level. A final indicator is a move away from reliance on broader markets for resource procurement and toward self-sufficiency (e.g., particularly among public power entities).

3. Transmission continues to be problematic and poses the biggest impediment to progress.

As in past roundtable discussions, the focus came repeatedly around to the inherent inadequacies of the current system in addressing transmission to promote workable competition and benefits to consumers. Many segments of the industry find transmission to be problematic, including independent power producers and public power. Chief among concerns is that some participants in markets like PJM have been burdened by locational marginal pricing (LMP) and "participant funding." Neither mechanism appears to promote incentives to build transmission for reliability and efficiency-enhancing trading, particularly for transmission owners who unduly profit from congestion and constraints on the grid.

It is now apparent that there has been less investment in transmission since the advent of RTOs. This is a likely outgrowth of a policy focus on RTO *membership* (to cure the access problem), as opposed to transmission *investment* (to ensure consistent reliability under a changed industry regime). These problems have prompted policy makers to give more favorable attention to the Transco model. Independent Transcos could have an advantage over RTOs for generating incentives to invest in transmission and interest in participating in grid maintenance and expansion projects. Transcos would also allow for the development of standalone transmission in a world where "bottom-up" transmission planning may not be workable anymore.[4]

[4] One participant noted the tension between the need to reconcile market power issues when electricity prices are not high enough to justify investment.

4. The current "model" of restructuring is incompatible with the realities of electricity markets.

This year's roundtable solidified a developing concern in past roundtable discussions—that the current model of restructuring is incompatible with the realities of electricity markets. There is a general consensus that the political unacceptability of reliability problems and price volatility have been the primary drivers of transitional problems. As a result, the view is that restructuring has largely moved toward a new form of regulation (as opposed to competition) or that there is retrenchment toward more traditional regulation.

At the root of this problem is the uneasy admission that electricity markets may not be inherently competitive. And while other deregulated markets routinely handle price volatility, electricity may be different because the risks of failure are so enormous. Thus, promoting competition in electricity may be like pounding a square peg into a round hole. The ineffectiveness of "deregulatory" competition in electricity has been exacerbated by a federal policy focus on short-term efficiency to promote competitive outcomes, but which has nonetheless *not* produced the needed investment and innovation for the long run.

Federal policy objectives have also been largely unaided by the states, who have not aggressively taken up restructuring because of political problems, jurisdictional tensions, and transmission issues. In light of these fundamental incompatibilities, much of the restructuring effort in the last few years has focused on "patching" problems within the current system. Under those circumstances, progress toward enhancing efficiency is likely to be "at the margins," which might put further policy initiatives and evidence on the costs and benefits of restructuring into a different, more critical light.

5. Removal of PUHCA restrictions and lack of evidence on merger-related benefits puts the spotlight on the competitive ramifications of further merger activity.

The workshop discussion concluded with observations on important recent developments in merger policy and activity. Some believe that the repeal of the PUHCA restrictions on holding company activities could have a significant impact on the industry, producing a trend toward consolidation that could approach that experienced in the U.S. railroad industry.

One tension that may emerge from a further wave of mergers will be the balance between merger-related benefits and anticompetitive effects. Since unbundling sacrifices economies of coordination, vertical integration through larger, more complex transactions may be an easier "sell" on the basis of cost savings and reliability. On the other hand, such efficiencies would have to be huge to outweigh the potential benefits of competition. Recent empirical evidence indicates that mergers consummated during the wave of the 1990s largely did not involve target firms that were less efficient than acquirers and also failed to prove up the predicted benefits.[5]

Concerns about further concentration of resources through merger and impaired market structures remain.[6] And while regulatory agencies (with a focus on conduct, instead of structural, remedies) are not the best line of defense for the review of a new crop of

---

[5] For more detail, see the presentation of John Kwoka, Northeastern University.

bigger and more complex mergers, antitrust still has not supplanted regulation in this arena. The role of state-level regulatory and antitrust enforcement in merger review also remains fuzzy.

Recommendations

Given the magnitude of concerns surrounding restructuring in electricity today, the roundtable discussion produced a number of individuals' suggestions for future policy direction—summarized as follows. At the root of our problems is the need to choose an appropriate goal for restructuring. If the goal is consumer welfare (and the consensus appears to support this) then it is clear that the current free-market approach is achieving the result only very indirectly, if at all. A more consumer-based model is in order. Regardless of the model, transmission investment and the availability of transmission service at predictable and stable prices is important. Current mechanisms for promoting these outcomes, however, may be lacking or (even worse) may work in the opposite direction.

To achieve these goals within the confines of the current focus on RTOs requires independent, regional entities that must be held accountable for alleviating bottlenecks and transmission planning. A transmission pricing regime that encourages investment is also needed. Finally, to the extent possible, FERC should take advantage of its newly-granted authority under the 2005 Energy Act to replicate in electricity transmission the process that produced needed investment in natural gas transportation infrastructure under open access.

---

[6]One participant noted the tension between promoting structural remedies in problematic merger cases and the possibility of re-regulated markets, under which structural reforms are less important.