

**Before the  
United States of America  
Federal Energy Regulatory Commission**

**Market-Based Rates for Public Utilities )**

**Docket No. RM04-7-000**

**Comment of the  
Federal Trade Commission**

July 16, 2004

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**I. Introduction and Summary**

The Federal Trade Commission (FTC or Commission) appreciates this opportunity to present its views concerning analytical methods for delineating markets and assessing market power. Currently, the Federal Energy Regulatory Commission (FERC) uses a four-pronged test to assess whether a wholesale electricity supplier has market power: (1) whether the supplier has generation market power, (2) whether the supplier has transmission market power, (3) whether the supplier can erect barriers to entry, and (4) whether there are concerns involving the supplier that relate to affiliate abuse and/or reciprocal dealing.<sup>1</sup> If the answers to these inquiries are “no,” the supplier is eligible to offer electricity for sale at market prices rather than at regulated rates.

Assuming economically sound assessments within each prong, FERC’s four-pronged test will yield informative indications of likely supplier market power. FERC may wish, however, to update the thresholds or screens that apply to each prong based on the significant experience FERC has obtained in monitoring wholesale market operations. This comment suggests appropriate thresholds or screens and, where applicable, methodologies to ensure sound analytical determinations for the various prongs (for example, FERC should base its generation market power analysis on the techniques and approaches outlined and discussed in the

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<sup>1</sup>FERC, “Initiation of Rulemaking Proceeding on Market-Based Rates and Notice of Technical Conference,” Docket No. RM04-7-000 at 1 (Apr. 14, 2004).

Department of Justice and Federal Trade Commission Horizontal Merger Guidelines<sup>2</sup>).

The Commission has stated repeatedly that consumers benefit when markets operate unburdened by substantial and durable market power.<sup>3</sup> Accordingly, if market power exists in a market for wholesale electric power, economically practicable policies that lessen this market power by reducing a high level of generation concentration, expanding the geographic market, lowering entry barriers, or increasing the price elasticity of demand are likely to enhance consumer welfare.

We applaud FERC's efforts to reevaluate its methodology for identifying market power to ensure that its diagnoses of market power are based on sound economic principles. The FTC and its staff have long supported FERC's efforts to improve its market power screens for

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<sup>2</sup>U.S. Dept. of Justice and Federal Trade Comm., Horizontal Merger Guidelines (Apr. 2, 1992, as revised Apr. 8, 1997) (Horizontal Merger Guidelines).

<sup>3</sup>*See, e.g.*, Letter of the Federal Trade Commission to Thomas E. Bliley, Chairman, House Committee on Commerce, on H.R. 2944, The Electricity Competition and Reliability Act (Jan. 14, 2000), *available at* <<http://www.ftc.gov/be/v000002.htm>>. Market power on the part of a seller is the ability profitably to maintain prices above competitive levels for a significant period of time. Horizontal Merger Guidelines, § 0.1, adopted by FERC as the analytical framework for use in evaluating the effects of electric utility mergers on market power. FERC, Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement, Order No. 592 (issued Dec. 18, 1996). High generation concentration does not in itself imply market power.

granting market-based rates<sup>4</sup> and for other purposes.<sup>5</sup>

The FTC is an independent agency responsible for maintaining competition and safeguarding the interests of consumers through enforcement of the antitrust and consumer protection laws and through competition advocacy. In the electric power industry, the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of resource allocation and reviews proposed mergers involving electric and gas utility companies. In the course of this work, as well as in antitrust research, investigations, and litigation, the Commission applies established principles and recent developments in legal and economic theory and empirical analysis to competition issues. As part of its competition advocacy program, the FTC has issued two Staff Reports on electric power industry restructuring issues at the wholesale and retail levels.<sup>6</sup> The FTC and its staff have also filed numerous competition advocacy comments on electricity restructuring efforts with FERC, the states, and international

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<sup>4</sup>*See, e.g.*, FTC Staff Comment on FERC Docket No. EL01-118-000 (Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization; Order Establishing Refund Effective Date and Proposing to Revise Market-Based Rate Authorization) (Jan. 7, 2002), *available at* <<http://www.ftc.gov/be/v020005.htm>>; FTC Comment on FERC Docket Nos. EL01-118-000 and EL01-118-001 (Investigation of Terms and Conditions of Public Utility Market-Based Rate Authorization) (Aug. 28, 2003) (FTC Market-Based Rate Authorization Comment), *available at* <<http://www.ftc.gov/be/v030014.pdf>>.

<sup>5</sup>*See, e.g.*, FTC Staff Comment on FERC Docket No. RM98-4-000 (Revised Filing Requirements for Merger Applicants) (Sept. 11, 1998), *available at* <<http://www.ftc.gov/be/v980022.htm>>.

<sup>6</sup>FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (July 2000) (FTC July 2000 Report), *available at* <<http://www.ftc.gov/be/v000009.htm>> (this report compiles previous comments that FTC staff had provided to various state and federal agencies); FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform, Focus on Retail Competition (Sept. 2001), *available at* <<http://www.ftc.gov/reports/elec/electricityreport.pdf>>.

competition organizations.<sup>7</sup>

## **II. FERC Has Gained Substantial Experience Monitoring Wholesale Electricity Markets and May Wish to Apply this Learning to the Four-Pronged Market Power Inquiry**

In the 15 years since FERC adopted the four-pronged test, wholesale market operations have evolved and FERC has gained significant experience in monitoring electric power markets. To correspond to these changing circumstances, FERC has undertaken several regulatory initiatives to ensure that the exercise of market power – in generation or transmission – does not hinder efficient operation of wholesale electricity markets by increasing prices or reducing output. These efforts include Orders 888, 889, and 2000, which require nondiscriminatory transmission access,

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<sup>7</sup>For a listing of comments, *see* <<http://www.ftc.gov/be/advofile.htm>>.

<sup>8</sup>FERC, Promoting Wholesale Competition Through Open Access Non-discriminatory Transmission Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Final Order, Order No. 888 (issued May 10, 1996); FERC, Open Access Same-Time Information System (Formerly Real-Time Information Networks) and Standards of Conduct, Final Order, Order No. 889 (issued May 10, 1996); FERC, Regional Transmission Organizations, Final Rule, Order No. 2000 (issued Dec. 20, 1999).

<sup>9</sup>FERC, Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement, Order No. 592 (issued Dec. 18, 1996).

<sup>10</sup>FERC, Standard Market Design, Docket No. RM01-12-000, Notice of Proposed Rulemaking (issued Aug. 12, 2002).

<sup>11</sup>FERC, Standardization of Generator Interconnection Agreements and Procedures, Final Rule, Order No. 2003 (issued July 24, 2003).

<sup>12</sup>FERC, Standards of Conduct for Transmission Providers, Final Rule, Order No. 2004 (issued Nov. 25, 2003).

proposals governing the solicitation processes utilities use to acquire wholesale supply<sup>13</sup> and the acquisition and disposition of merchant generation assets.<sup>14</sup>

Through these initiatives, FERC has begun to identify best practices or best institutions that relate to the four prongs. FERC may want to capitalize on this progress by revising screens or thresholds for each of the four prongs that public utilities must satisfy or comply with in order to obtain authority to charge market-based rates. Of course, FERC also may want to specify the types of evidence that it may consider if an applicant does not meet the initial thresholds or screens.

**A. FERC May Want to Update Its Methodology for Delineating Relevant Markets to Improve Its Generation Market Power Assessments**

Recently FERC has adopted “interim” standards for assessing whether an applicant for market-based rates has generation market power.<sup>15</sup> The revisions include two indicative screens for assessing market power – one screen that assesses possible exercises of unilateral market power and another that focuses on the risk of coordinated interaction. FERC’s inclusion of a screen that relates to the risk of coordinated interaction is a sound addition to its generation market power analysis.<sup>16</sup>

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<sup>13</sup>FERC, Solicitation Processes For Public Utilities, Docket No. PL04-6-000, Notice of Technical Conference (May 11, 2004).

<sup>14</sup>FERC, Acquisition and Disposition of Merchant Generation Assets by Public Utilities, Docket No. PL04-9-000, Notice of Technical Conference (May 11, 2004).

<sup>15</sup>FERC, AEP Power Marketing, Inc., et al., Docket Nos. ER96-2496-106, et al., Order on Rehearing and Modifying Interim Generation Market Power Analysis and Mitigation Policy (issued Apr. 14, 2004) (FERC Interim Generation Market Power Order).

<sup>16</sup>To assess the risk of coordinated interaction, FERC should use a screen based on a concentration measure such as the Herfindahl-Hirschman Index (HHI). The HHI is calculated by summing the squares of the individual market shares of all the participants in a properly

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delineated (product and geographic) market. The HHI reflects the distribution and relative magnitude of market shares of the firms in the relevant market, and gives proportionately greater

occur in multi-year cycles. As a result, variations in market power due to variations in hydrological conditions are unlikely to be well represented by seasonal measures of capacity. Thus, even apart from the issues of properly defining the relevant markets discussed below, FERC's methodology to assess market power may not accurately reflect competitive dynamics in wholesale energy markets.

**1. FERC Should Assess Market Power Within Relevant Product Markets**

Before FERC can evaluate whether an applicant is likely to have market power, it must accurately delineate relevant product markets in which to make these evaluations. The agency should delineate product markets using the hypothetical monopolist test of the Horizontal Merger Guidelines: a relevant product market is a product or group of products such that a hypothetical profit-maximizing firm would impose at least a "small but significant and nontransitory" increase in price.<sup>18</sup> This analysis involves determining whether the pricing in a hypothesized product market is so constrained by competition from products outside that proposed market that additional products should be included in the same market.

Electricity product markets are delineated for different seasons and times of the day because supply and demand conditions in energy markets vary over time and cross-price elasticities of supply and demand are generally very low between different time periods.

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<sup>18</sup>Horizontal Merger Guidelines, § 1.0.

dispatchable gas-fired generating units are included in markets for on-peak energy.

Market power screens should accurately gauge whether suppliers are likely to have market power in the products for which they seek approval of market-based rates. In addition to product markets for electric energy based on the season and the time of day at which the electricity is supplied, there are markets for certain other electric power products. In regions where utilities have obligations to maintain generating capacity reserves, there may be markets for generating capacity rights. There may be markets for such products as spinning reserves and voltage control that FERC may wish to examine.

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<sup>19</sup>See FTC Market-Based Rate Authorization Comment, *supra* note 4, at 6-7.

<sup>20</sup>See Ronald J. Binz and Mark W. Frankena, “Addressing Market Power, The Next Step in Electric Restructuring,” Competition Policy Institute, at 37 (1998).

<sup>21</sup>If the geographic market is delineated too broadly, applicants with market power in narrower relevant markets may pass the screen (Type II error). If the geographic market is

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delineated too narrowly, applicants without market power may fail the screen (Type I error). However, an excessively broad market also may result in Type I errors, while an excessively narrow market also may result in Type II errors, such as when a supplier has a larger share in a broader area than in a narrower one. *See* Mark W. Frankena, “Analyzing Market Power Using Appendix A of FERC’s Merger Policy Statement: Rationale, Reliability, and Results,” CCH Power and Telecom Law

An appropriate computer simulation model can be used to delineate relevant geographic markets based on the hypothetical monopolist methodology. The Horizontal Merger Guidelines describe a geographic market (absent price discrimination) as a region in which a hypothetical monopolist – i.e., the only present and future producer of the relevant product at locations in that region – would profitably impose at least a small but significant and nontransitory increase in price, holding constant the terms of sale for all products produced elsewhere.<sup>24</sup> In the absence of transmission constraints, it is likely to be difficult to delineate appropriate geographic markets (particularly for the wide variety of demand and supply conditions often experienced in the electricity industry<sup>25</sup>) without using a computer simulation model.

Simulation models also can be used for other purposes. These models can help predict the effects of many types of changes in the industry – for example, a change in demand for electric energy in one area, in transmission capacity, or in natural gas prices. Simulation models can be used to explore a merger’s potential to produce certain types of competitive effects -- for example, whether the merger would increase the incentives of the acquiring company to withhold output of electric energy in order to raise market prices and its own profits. Computer simulation models are helpful because they allow one to take into consideration whether other firms would have the incentive and ability to expand output sufficiently to make such a price increase unprofitable. They also can be used to evaluate potential remedies for market power.

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Marketing”). See Philip Kotler, *Marketing Management* Prentice-Hall, 11th ed. 2002).

<sup>24</sup>Horizontal Merger Guidelines, § 1.21.

<sup>25</sup>Because electric power cannot generally be inventoried, each time period is likely to represent a separate product market, and relevant geographic markets may differ among these time periods.

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<sup>26</sup>*See, e.g.*, Scott M. Harvey and William W. Hogan, “Market Power and Market Simulations” (July 16, 2002), *available at* <[http://ksghome.harvard.edu/~.whogan.cbg.Ksg/H-H\\_Market\\_Power&Simulations\\_071602.pdf](http://ksghome.harvard.edu/~.whogan.cbg.Ksg/H-H_Market_Power&Simulations_071602.pdf)>.

<sup>27</sup> The U.S. Department of Energy expended substantial resources to access an existing commercial model and to use its own in-house model to evaluate the effects of FERC’s standard

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<sup>29</sup> *See*

insights from its experience with Orders 888, 889, and 2000. Accordingly, a utility that has

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<sup>30</sup>Incentives to discriminate stemming from contractual relationships, however, may also warrant analysis. An example may be a transmission utility that has a marketing affiliate with long-term power purchase contracts in the same area.

<sup>31</sup>The Horizontal Merger Guidelines (§ 3.0) define ease of entry in the merger context as entry that “is so easy that market participants, after the merger, either collectively or unilaterally could not profitably maintain a price increase above premerger levels. Such entry likely will deter an anticompetitive merger in its incipiency, or deter or counteract the competitive effects of concern.”

conditions by FERC should consider both generation and transmission. FERC's focus for the entry barriers prong, however, is more specific: FERC focuses on the *creation* of entry barriers by applicants for market-based rates.

In refining the application of this screen, FERC may wish to consider its recent experience concerning interconnection rules and transmission expansions by RTOs. FERC's interconnection rules derived in part from its concern that vertically integrated utilities may have incentives and the ability to protect their generation assets from competition by delaying or increasing the costs for independent generators that wish to connect to the transmission system. Connection to the transmission system is a necessary element for generation entry that is not on the customer's site, and compliance with the interconnection rules provides one indication that an applicant is not creating barriers to generation entry.

Similarly, FERC has developed procedures in RTOs to identify and undertake economically efficient transmission expansion projects, although significant problems remain in achieving timely and economically efficient grid expansions. FERC's grid expansion procedures are motivated in part by concern that vertically integrated utilities may have incentives to postpone or avoid transmission expansions that would facilitate access for new generation

#### **D. Potential Elements of the Affiliate Abuse Screen**

The recent FTC comment on utilities' solicitation processes discusses recent FERC concerns about evasion of rate regulation, discrimination, and cross-subsidization in transactions between utilities and their unregulated affiliates.<sup>32</sup> FERC's existing policies in these areas may be modified as the result of this recent review. One possible insight from FERC's review of these policies relates to the potential role of independent third parties in assessing the market value of transactions between a utility and its affiliates.<sup>33</sup> FERC may want to include compliance with any new policies in this area as a prerequisite to passing the affiliate abuse screen. A utility with a record of violations of these policies would bear the burden of proof that it passes the affiliate abuse prong.

#### **III. Conclusion**

FERC has gained substantial experience in monitoring wholesale market operations in the 15 years since it introduced its four-pronged test to assess whether a supplier may sell its supply at market prices. Assuming economically sound assessments within each prong, the four-pronged test will yield accurate determinations of supplier market power. FERC may want to

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<sup>32</sup>See Comment of the FTC on FERC Docket Nos. PL04-6-000 and PL04-9-000 (Solicitation Processes for Public Utilities Acquisition and Disposition of Merchant Generation Assets by Public Utilities) (filed July 14, 2004).

<sup>33</sup>*Id.* at 12-13. The FTC has experience in both antitrust law enforcement and consumer protection regarding the use of independent third parties to avoid discriminatory decisions by affiliates. For example, the settlement of the DTE/MichCon merger case provides for an independent third-party evaluation of the prices and services offered by the electric utility's (i.e., DTE) natural gas distribution affiliate, MichCon, to an entrant that shares the natural gas distribution system with MichCon. This entrant competes with DTE for customers choosing between electricity and natural gas, including electricity customers considering switching to on-site electric power generation fueled by natural gas.

update the thresholds or screens that apply to each prong based on FERC's significant experience in monitoring wholesale market operations. FERC also may want to specify evidence that it would consider to cross the threshold or rebut the presumption adopted for each relevant prong.