



UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

**BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION
DEPARTMENT OF ENERGY**

WASHINGTON, D.C.

In The Matter of

**Promoting Wholesale Competition Through
Open Access Non-discriminatory Transmission
Services by Public Utilities, Recovery of
Stranded Costs by Public Utilities and
Transmitting Utilities;**

**Proposed Rulemaking and
Supplemental Notice of Proposed Rulemaking**

Docket Nos. RM95-8-000 & RM94-7-001

**Comment of the Staff of the
Bureau of Economics of the Federal Trade Commission(1)**

August 7, 1995

I. Introduction and Summary.

The staff of the Bureau of Economics of the Federal Trade Commission (FTC)(1) appreciates this opportunity to respond to the Federal Energy Regulatory Commission's (FERC) notice of proposed rulemaking.(2) The staff of the FTC has a longstanding interest in regulation and competition in energy markets, including proposals to reform regulation of the natural gas and electric power industries.(3)

Competitive opportunities in the generation of electric power have burgeoned in the last decade, stimulated by changes in relative costs of different types of generating plants and by changes in laws and regulations. But economic benefits for consumers of greater competition may be thwarted by features of the industry's traditional vertically-integrated structure and regulation. To remove obstacles to increased competition, FERC proposes rules that would call for utilities to offer open, non-discriminatory access to wholesale transmission services. To address issues that are likely to delay the transition to a more competitive market environment, FERC proposes rules to govern recovery of "stranded costs," which FERC describes as uneconomic costs (primarily generation) that a utility has already incurred. We fully support the intention of FERC's efforts, to promote greater competition in this industry so that the benefits of greater efficiency can promote lower electricity rates for consumers. Our comments address aspects of the particular methods FERC has proposed and assess how variations on FERC's proposals might accomplish its goals more effectively.

Operational unbundling would likely be more effective than functional unbundling and less costly than industry-wide divestiture. FERC's plan for "functional unbundling" of power generation from transmission services addresses a critical competitive issue by requiring vertically integrated utilities to grant open access and equal treatment to their competitors. This approach, however, would leave in place the incentive and the opportunity for some utilities to exercise market power in the regulated system. Preventing them from doing so by enforcing regulations to control their behavior may prove difficult. The problem would be most effectively prevented by completely separating ownership and control of generation from transmission. This separation would remove both the incentive and the opportunity to exercise market power, by eliminating the utilities' ability to discriminate in favor of their own generation operations. The additional benefits of full divestiture may be outweighed, however, by the costs and difficulties of implementing it industry-wide. It may be sufficient to require "operational unbundling," in which the dispatch of generating capacity and/or the operation of the transmission grid would be controlled by an independent entity. Operational unbundling could prevent discrimination and achieve the competitive benefits of open access more effectively and efficiently than would an attempt to mandate, regulate, and monitor access. In addition, operational unbundling would not incur the costs of full divestiture.

Competition problems in concentrated generation markets must still be addressed under open access. Open access will affect, but not obviate, FERC's assessment of competitive conditions in electric power generation, including its analysis of "generator dominance." The DOJ/FTC Horizontal Merger Guidelines show how to evaluate likely competitive effects of concentration among suppliers and changes in market contours. Expanding the number of suppliers potentially available is likely to make the electric power system more efficient and more competitive, but there may be circumstances, even under open access conditions, in which dominant suppliers might be able to exercise market power. Competitive conditions among mid-cost plants could be particularly significant.

Efficient transmission pricing must accompany open access. Pro-competitive reforms will not achieve their objectives, and might even prove counterproductive, unless prices and terms for transmission services also become economically efficient signals about investment and output. Achieving the economic benefits of unbundling will therefore depend strongly upon FERC's concurrent reform of transmission pricing. An aspect of efficient transmission pricing is the regime for resale of transmission rights in secondary markets, which will be especially important if FERC opts for functional unbundling alone. For secondary markets to perform their pro-competitive functions effectively, the cap on resale prices should be removed, so that prices for resales can become economically accurate signals about

The problem FERC is addressing is the risk that vertically integrated transmission monopolists will control access to transmission services in ways that inefficiently favor their own generation operations.(4) As long as all stages of the industry were regulated jointly as monopolies, the problem did not attract regulatory attention. It arises now because one stage of the industry, generation, is becoming more competitive.

A. Preventing Discrimination or Cost Shifting by a Regulated Monopolist Is Difficult.

A monopolist whose rate of return is regulated has an incentive to evade the regulatory constraint in order to earn a higher profit. Its participation in an unregulated market may give it the means to do so, either by discriminating against its competitors in the unregulated market or by shifting costs between the regulated and unregulated markets.(5)

The discrimination strategy involves complementary products. The monopolist controls others' access to its regulated product in ways that permit it to earn supra-competitive returns in its own operations involving the unregulated complement. Discrimination could appear as a subtle reduction in quality of service, whose effects would be more difficult to identify and measure than outright denial of access. An integrated transmission monopolist might afford other generation sources access to its transmission services only on terms that raise others' costs and permit the monopolist to make supra-competitive profits in the generation market.

The cross-subsidization or cost-shifting strategy involves inputs used for both regulated and unregulated products. Costs of the shared inputs, which in the electric power industry might include scheduling and general overhead, are assigned to the regulated business to justify higher cost-based rates there. This shifting distorts competition and produces inefficiencies in the unregulated business as well. Controlling the discrimination and cost-shifting strategies with monitoring and regulation is difficult. They can be defeated most effectively by preventing the regulated monopolist from entering the unregulated business, thus eliminating its ability to distort competition in the unregulated market.

B. Operational Unbundling Is Likely to be More Effective And Less Costly Than Functional Unbundling in this Industry.

not higher — that nondiscriminatory practices and rates will prevail.(13) Operational unbundling would not incur the costs of enforcing behavioral rules, because the firms would have less incentive and ability to discriminate. It should be at least as effective as functional unbundling in ensuring against discrimination, and it would be much less costly to implement than divestiture, because only operation, not ownership, would be structurally separated.(14)

III. Competitive Conditions In Generation Must Still Be Monitored Under Open Access.

A factor in whether FERC will approve use of market-based rates for power is its assessment of competitive conditions in power generation.(15) Here, FERC asks whether, under an equal access requirement, regulation of prices for generated power can be relaxed or eliminated. The answer is, not necessarily. Although open access may lead to sufficient competition in some markets, FERC should still examine actual market concentration and competitive conditions in determining whether to loosen regulation.

A useful framework for examining the competitive effects of industry concentration and other market characteristics is set out in the Horizontal Merger Guidelines issued in 1992 by the Department of Justice and the Federal Trade Commission.(16) Under the Horizontal Merger Guidelines, product and geographic markets are defined in terms of the ability of a hypothetical monopolist to profit from a small (typically five percent), non transitory increase in prices for the product within the area. Market concentration is evaluated for that product and that geographic area.(17) Antitrust analysis usually anticipates that, if concentration is high, anticompetitive effects such as coordinated interaction (collusion) or unilateral market power will be more likely, in the absence of ameliorating factors such as easy entry.(18) If the entry of new competition will rapidly and effectively constrain a price increase, then a dominant firm or collusive group probably could not exercise market power even in a concentrated market.(19)

Introducing open access to transmission would not prevent completely the exercise of market power in generation, but it is likely to limit the situations of competitive concern about market dominance. Open access could broaden the relevant geographic market for generation by alleviating impediments to wholesale wheeling. Broadening geographic markets typically results in lower concentration and thus reduced risk of market power. Opening a system to a larger number of generating plants could also lead to operating efficiencies, by more completely capturing gains from trade among facilities with different costs and by reducing the system's reserve requirements. Open access could increase the likelihood that a price increase will be met by time)

We support FERC's efforts to identify generation markets where regulation can be relaxed. Where a generation market is found to be competitive, market based pricing should be permitted, or the benefits of industry restructuring will be limited or lost.

IV. Efficiency Gains from Open Access Depend on Concurrent Reform of Transmission Pricing.

A. Transmission Rates Must Be Made Responsive To Economically Relevant Criteria.

Economically efficient transmission rates will be vital to obtaining the potential efficiency benefits of open access.⁽²⁶⁾ The transmission grid is likely to remain a regulated monopoly, no matter what method is used to ensure or encourage open access to it. FERC acknowledges that current "postage stamp" transmission rates are not sensitive to distance and actual electricity flows, and thus may not lead to economically efficient employment of, or investment in, generating capacity.⁽²⁷⁾ Unless transmission rates are economically efficient, open

owners at that point might exercise market power to elevate prices even above the scarcity rents. A secondary market, by increasing the number of participants, could provide alternative sources and thus help avoid such an exercise of market power.

Because it would serve several important economic functions, a secondary market for transmission services should be permitted and even encouraged to develop fully and rapidly.

C. Restrictions on Prices in Secondary Transmission Markets May Limit Efficiency Gains from Open Access.

FERC forbids resale of transmission rights at a price higher than what the utility was initially paid for them.⁽³²⁾ FERC asks whether this restriction should be lifted. Lifting this price ceiling would permit important economic efficiency gains from open access to be realized.⁽³³⁾ A particularly important effect relates to FERC's proposal about expansion of the transmission grid.

FERC's proposal would require that a public utility expand its wholesale transmission grid when customers apply for such service (and supply appropriate financial guarantees). But building new transmission capacity may not be the lowest cost way for a new customer to obtain point-to-point transmission service. Instead, the service might be obtained more cheaply by buying transmission rights from a current user who values them less than the new customer does. This efficient resale transaction would be discouraged if the current user could not charge a price high enough to make reselling the rights attractive. Customers whose demand is too small to justify their investment in new transmission capacity, but great enough to justify paying a price higher than current customers could accept to release their transmission rights, could be frustrated.

If the cap on resale prices is removed, current transmission customers would face an opportunity cost for their transmission service — that is, the value of the alternative use of the service

whatever reasons, c

None of the alternative mitigation approaches is perfect. Coordination between methods used by the states and by FERC to account for mitigation savings may be important in providing a smooth and swift transition to increased competition. Differences in treatment and different levels of incentive to mitigate may lead to uncertainty about the amount of mitigation that will be recognized and hence about the amount of customers' net stranded cost liability. Uncertainty about the magnitude of the risk and about who would shoulder it could delay or diminish interest in open access, in turn delaying the establishment of competition in power generation.⁽⁵⁰⁾ Coordination among FERC and state regulators may reduce confusion, complexity, and litigation delays.

C. Stranded Costs Might Be Recovered From the Entire Customer Base That Benefitted From These Costs.

FERC proposes to assign stranded costs to individual departing customers, so that stranded wholesale generation costs will be assessed and recovered on a utility-by-utility basis.⁽⁵¹⁾ This approach would lead to high surcharges in areas served by utilities with high stranded costs and little or no such charges in some other areas. Some investments that now appear as stranded costs may have been intended to benefit customers over a wider area than a single utility.⁽⁵²⁾ Arguably, stranded costs that benefitted broader groups of customers should be collected from that broader group of customers if the stranded cost recovery program is to function as a user fee. A broader scope could also cushion the "rate shock" to remaining customers. National or regional assessment methods

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(1) This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any indi

(3) The staff of the FTC has commented on electric power regulat

(10) A major transaction cost of achieving full divestiture of public utility firms would be litigation about compliance with coverage ratio requirements in their bond covenants. In addition, changing ownership of nuclear power facilities will be a complex and difficult task, involving more stringent asset coverage ratios. These problems would be

(20) FERC's decisions about wholesale interstate transmission pricing methodology are likely to have a significant impact on the definition of the relevant geographic market. Distance charges should provide more efficient signals for transmission decisions than do "postage-stamp" charges, which are independent of actual distance, since transmission costs are more strongly related to distance than to the number of utility territories crossed. Geographic markets defined with respect to distance charges should correspond to underlying cost conditions more accurately than market defined with respect to postage- stamp pricing. Whether t

(21) David Newberry, *Power Markets and Market Power* (1995, unpublished). In the U.K. system, "merit dispatch" — that is, use of the lowest price sources to meet projected demand — for each half hour is based on bids submitted the previous day. Thus, there are thousands of separate electricity "markets" each year, denominated by

(22) Newberry, *supra* note 21; see also South Carolina Comment, *supra* note 3, at 52-53, which observed:

Evaluators of the British system have emphasized one major drawback in the manner the reforms have been implemented. Although there are ten generator firms, the structure of the generating industry is essentially a duopoly because the government's generation capacity was divided into only two entities. Consequently, these two firms may be in a position to affect the market clearing price substantially, by withholding even a small portion of their capacity. In an effort to discourage strategic capacity withholding, new franchising rules require an operationally capable plant to offer a bid and require the m

(23) Newberry, *supra* note 21. In the U.K., nuclear plants, with their low marginid/04 T bi l0.002 , 3(uc)a615(h t)2(he)13(i)-1(r)4(l)-1(ow

(33) A general policy of lifting the ceiling on prices for resale of transmission service rights need not be inconsistent with a program of temporary,

(34) The remaining customers' incentive to resist expansion of wholesale transmission capacity does not depend on whether power costs in the utility's service area are high or low. Curtailing expansion could discourage customers in a high-cost area from exiting to seek cheaper "imported" power elsewhere, and fewer exiting customers would mean fewer potentially stranded costs. Curtailing expansion could discourage potential customers outside a low-cost area from bidding for cheap power to "export" from the area, and without that additional demand local power prices might

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