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

Before the Louisiana Public Service Commission
Regarding "Market Structure, Market Power, Reliability, and ISOs"

Docket Number U-21453

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

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to respond to the invitation to comment of the Louisiana Public Service Commission (PSC) concerning the "Market Structure, Market Power, Reliability, and ISOs" portion of its "investigation into whether electric industry restructuring and competition in the provision of retail electric service is in the public interest."(3)

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. The staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy. In the course of this work, as well as in antitrust research, investigation,

Recently, computer simulation models of generation and transmission that may facilitate analysis of market power issues have become more widely recognized and tractable.

V. ISOs Are Potentially Attractive Institutions for Addressing Many Market Power Issues in the Electric Industry

Both horizontal market power and transmission discrimination concerns can be addressed by ISOs. ISOs can be organized to reduce potential horizontal market power by including a broad geographic area with many separate generation firms. By eliminating pancaked transmission rates(16) and embracing an enlarged geographic area, ISOs can broaden the effective geographic market and thereby reduce market concentration in generation and consequently the likelihood of generation market power. A broader geographic market will not necessarily solve all the generation market power problems, but it can provide a major step in that direction.

If it is truly independent in its governance and operations, the ISO also eliminates transmission discrimination incentives by removing control of transmission assets from the hands of firms that own generation facilities. In addition, the ISO may have stronger incentives than traditional vertically integrated utilities to address generation market power in load pockets(17) that arise during periods of transmission congestion.(18)

If Louisiana becomes involved in the formation of an ISO, it may wish to consider four danger signs warning of risks to competition in the ISO formation process:(19) (1) the ISO is too small; (2) there is no plan for generation restructuring; (3) the ISO is not sufficiently independent; and (4) the ISO plan does not effectively deal with transmission congestion.

ISO Warning Sign Number One: The ISO is too small. One disadvantage of an ISO with limited geographic scope is that it may not encompass enough generating firms to mitigate generator market dominance problems. (20) With very few, if any, exceptions, a single state is too small for an ISO. An ISO that includes only one utility's service territory warrants even closer scrutiny. In contrast, several participants at FERC's April, 1998 ISO Policy Conference testified that reliability and competition concerns might lead to consolidation into as few as three ISOs to cover all forty-eight contiguous states.

ISO Warning Sign Number Two: There is no plan for generation restructuring even when there is a potential generation market dominance problem. As a general proposition, a market power monitoring office within the ISO may not be a good substitute for up-front divestiture of generation capacity if market power is present. Several states, including California, have confronted the generation market dominance issue directly and required divestitures of key generation capacity in conjunction with forming an ISO. As noted earlier, antitrust may not be an effective policy tool for addressing existing market power created under past regulation. Hence, the PSC, other state public utility commissions, and FERC may be in the best position to address this aspect of restructuring as part of the ISO formation process.(21)

ISO Warning Sign Number Three: The "I" part of the ISO is missing or weak. Independence is a keystone of successfully launching competition through an ISO. For competition to develop, current and prospective industry participants need to have trust in the objectivity of the ISO. If, for example, incumbent vertically integrated utilities can veto expansions of the transmission grid, or limit who may use the grid, the ISO's independence is likely to be at risk.(22)

ISO Warning Sign Number Four: The ISO plan does not effectively deal with transmission congestion.(23) Failure to deal effectively with the transmission congestion problem can threaten system stability, present opportunities for generators to create or protect generation market power, and reduce the overall efficiency of the

Although the issues of competition and reliability are commonly discussed separately, there is a major overlap between the two that relates to the appropriate size of the ISO. As discussed above, large ISOs can alleviate generation market dominance concerns by broadening the relevant geographic market and by providing unbiased

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17. A "load pocket" refers to demand in an area that must be satisfied by generation in that area because transmission congestion prevents utilization of supplies from outside the area.

18. One potential difficulty with the nonprofit status of ISOs is the lack of profit incentives to operate efficiently and to make economically appropriate investment decisions regarding expansion of the transmission grid to address transmission bottlenecks. ISO governing bodies may be able to design the employment contracts of ISO managers to provide such incentives.

19. Additional guidelines on formation of ISOs have been issued by FERC in Order No. 888, F.E.R.C. Stats. & Regs. (CCH) ¶31,036 (April 24, 1996) (Promoting Wholesale Competition Through Open Access Non-Discriminatory Transmission Services by Public Utilities; Recovery of Stranded Costs by Public Utilities and Transmitting Utilities), and Order No. 889, F.E.R.C. Stats. & Regs. (CCH) ¶31,594 (April 24, 1996) (Open Access Same-Time Information System and Standards of Conduct).

20. Another disadvantage may be that it does not provide enough diversity in generation (with respect to number and type of generators) to optimize system reliability. See Section VI below.

21. The Administration's recent proposals respond to this concern by giving FERC authority to require divestiture of generation assets by generating firms that have market power in the context of retail competition. ("Comprehensive Electricity Competition Plan," March 26, 1998 (www.hr.doe.gov/electric/plan.htm).)

22. See James Baker Jr., Bernard Tennebaum, and Fiona Wolf, Governance and Regulation of Power Pools and System Operators: An International Comparison, 382 World Bank Technical Papers (1997) (a report on international comparisons of ISO governance systems written in part by FERC staff).

23. "Transmission congestion" refers to conditions in which transmission lines are being used to full capacity and additional transmission efforts between a generator and load reduce the efficiency of other transmissions on the transmission grid. Transmission congestion is most likely during peak demand (load) periods.

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