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

July 15, 1998

Before the

PUBLIC SERVICE COMMISSION OF WEST VIRGINIA CHARLESTON

General investigation to determine whether West Virginia should adopt a plan for open access to the electric power supply market and for the development of a deregulation plan.

Case No. 98-0452-E-GI

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) submits these comments in the above-captioned proceeding concerning whether electric industry regulatory reform and competition in the provision of retail electric service is in the public interest. In addition, we provide comments on the restructuring plans submitted by American Electric Power (AEP) and Allegheny Power (Allegheny) in this proceeding. With initiation of this proceeding, West Virginia is joining a growing list of states considering regulatory reforms to bring the benefits of increased competition (lower prices, improved service, and innovation) in the electric industry to its citizens and businesses.

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, and litigation, the staff applies established principles and recent developments in economic theory and empirical analysis to competition issues.

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. Staff has submitted numerous comments concerning these issues at both the federal and state levels.(2)

several competition policy themes to assure that the benefits of competition inure to consumers and businesses in West Virginia. The five primary themes of our comment are: (1) both horizontal market power and discrimination against competing suppliers of generation by vertically integrated transmission monopolists may be of concern in the electric industry; (2) there are several appropriate factors to consider in a market power analysis, and the PSC may wish to avail itself of computer simulation models to help examine these factors as well as to evaluate current and prospective horizontal market power;(3) (3) if West Virginia determines that it faces likely market power problems in electric generation markets, addressing them through structural remedies may be preferable to relying exclusively on market power monitoring and mitigation; (4) independent system operators (ISOs) of the transmission network within a defined geographic region are potentially attractive institutions for addressing some of the market power issues in the electric industry, particularly if the ISO is formed to avoid the dangers signaled by four key ISO warning signs -- insufficient size, lack of a contingency plan for generation restructuring, lack of independence, and failure to adequately deal with transmission congestion; and (5) properly developed and operated ISOs also may help address reliability concerns.

In addition to these five themes, we provide five comments on the regulatory reform plans submitted to the PSC by AEP and Allegheny, two utilities operating in West Virginia. First, the PSC may wish to consider structural remedies, including divestiture of generation facilities to multiple buyers, if generation market power is likely in West Virginia. Second, the PSC may wish to follow other jurisdictions in adopting rate caps during the transition to retail competition. Third, if the PSC implements fees to recover stranded costs, it may wish to design such fees to minimize distortions in future electricity purchases and provide incentives for mitigation of stranded costs. Fourth, the PSC may wish to assess whether its electric suppliers should join an existing ISO or participate in formation of an additional ISO, which may postpone realizing the benefits of operational unbundling in West Virginia. Finally, the PSC may wish to evaluate methods to more effectively address the issue of discrimination and cross-subsidization in transactions between

PSC may wish to distinguish in its analysis of market power between present market power and one or more future market power scenarios. Further, it may wish to facilitate the emergence of competitive supplies of electricity by assuring that existing regulations and procedures governing new or increased transmission capacity are not unnecessarily restrictive, costly, or time consuming.

A second example of the likely effects of technological change on competition is time-of-day metering for consumers, as well as for additional businesses. While no one knows what the effects will be of expanded time-of-day metering, it is likely that consumers will shift their use of electricity to take advantage of lower rates during off-peak periods and to minimize their use of electric power during peak periods.(12)

Both horizontal market power and transmission discrimination concerns can be addressed by independent system operators (ISOs).

forth in the DOJ/FTC Merger Guidelines, together with computer models, may allow the PSC to draw appropriate conclusions about the extent of generation market power facing West Virginia customers. In conducting such a market power analysis, the PSC may wish to distinguish between present market power and likely future market power, since technological and institutional changes may materially alter generation market power (as they have in the past). A carefully formed ISO may be an attractive institution through which to implement retail competition and enhance wholesale competition. One criterion for an effective ISO is likely to be significant geographic size, with numerous generating facilities and firms. A large ISO of this type is apt both to alleviate generation market power and to enhance reliability. The PSC may wish to evaluate whether its franchised utilities should join an existing ISO or wait for a new ISO to be formed. The PSC also may wish to evaluate how to assure that transactions between regulated parent utilities and their affiliates do not harm competition or consumers.

Respectfully submitted,

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July 15, 1998

Endnotes

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 individual Commissioner. Inquiries regarding this comment should be directed to John C. Hilke (303-844-3565).

2 The staff of the FTC has commented on electric power regulation to the Federal Energy Regulatory Commission (FERC) in Docket No. PL98-5-000 (May 1, 1998)(ISO Policy Comment), Docket Nos. ER97-237-000 and ER97-1079-000 (February 6, 1998)(New England Power Pool (NEPOOL) Comment), Docket No. RM96-6-000 (May 7, 1996), Docket Nos. RM95-8-000 and RM94-7-001 (August 7, 1995), and Docket No. RM85-1-000 (1985). Comments to state agencies have been submitted to the Commonwealth of Virginia, Joint Subcommittee Studying Electric Industry Restructuring, SJR-91 (July 9, 1998); the Public Utilities Commission of Texas, Project Number 17549 (June 19, 1998); the Maine Department of the Attorney General and Public Utilities Commission, "Interim Report on Market Power in Electricity" (May 29, 1998); the Louisiana Public Service Commission, Docket No. U-21453 (May 15, 1998); the California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032 (August 23, 1995); and the South Carolina Legislative Audit Council (February 28, 1994).

3 These factors are described in the U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, issued April 2, 1992, revised April 8, 1997. The Guidelines provide a sound framework for evaluating horizontal market power issues in a merger context, but they are not designed to address existing market power that was lawfully acquired, as might well exist in an industry moving from local regulated monopolies to competition.

4 See

25 We note that some rate cap plans have an adjustment for inflation as well as a modest annual decrease in rates over time to reflect productivity improvements that should allow the regulated utility to reduce its costs. For example, rates charged by the National Grid Company in the United Kingdom are allowed to increase by the retail price index, but are reduced by a target rate of real price decrease to reflect productivity gains. Vernon Smith, "Regulatory Reform in the Electric Industry" 16 (Goldwater Institute) (1993). Neither of the plans submitted to the PSC includes a productivity adjustment of the rate caps.

26 "Stranded costs" are market values of utility assets that are below regulatory embedded costs.