



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

**Before the Commonwealth of Virginia
Joint Subcommittee Studying
Electric Utility Restructuring
Structure and Transition Task Force**

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) submits these comments to the Structure and Transition Task Force of the Virginia Legislature's Joint Subcommittee Studying Electric Utility Restructuring (Task Force) concerning electric industry regulatory reform. With the formation of the Task Force, Virginia is joining a growing list of states considering regulatory reforms to bring more of the benefits of 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⁾ Moreover, the FTC regularly reviews proposed mergers involving electric and gas utility companies.

In the transition to retail competition, the Task Force may wish to consider several competition policy themes to assure that the benefits of competition inure to consumers and businesses in 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 factors to consider in a market power analysis, and the Task Force 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 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 warning signs -- insufficient size, lack of a contingency plan for

If Virginia becomes involved in forming an ISO, it may wish to consider four danger signs warning of risks to competition in the ISO formation process:⁽¹⁷⁾ (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.⁽¹⁸⁾ 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. Indeed, 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 Task Force, 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.⁽¹⁹⁾

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 f* BTscn /TT0 1 T848uSO. If f* BTscn /TT0 1 T848uog m476.5201 T

competition and consumer protection perspectives, in our recently filed comment to the Public Utility Commission of Texas and we believe that it may be of interest to the Task Force. This comment can be found at the FTC's website (www.ftc.gov/be/advofile.htm).

VIII. Conclusion

Horizontal market power and transmission discrimination issues warrant close attention from the Task Force as it moves to secure the benefits of retail competition for Virginia's citizens and businesses. Use of the factors set forth in the DOJ/FTC Merger Guidelines, together with computer models, may allow the Task Force to draw appropriate conclusions about the extent of generation market power facing Virginia customers. In conducting such a market power analysis, the Task Force 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

(4) See Timothy Brennan, Why Regulated Firms Should Be Kept Out of Unregulated Markets: Understanding the Divestiture in United States v. AT&T, 32 Antitrust Bull. 741 (1987), and Cross Subsidization and Cost Misallocation by Regulated Monopolists, 2 J. Reg. Econ. 37 (1990).

(5) See, e.g., "Petition for a Rulemaking on Electric Power Industry Structure and Commercial Practices and Motion to Clarify and Reconsider Certain Open-Access Commercial Practices," filed with FERC by Altra Energy Technologies, Inc. and others on March 25, 1998.

(6) Otter Tail Power Co. v. United States, 410 U.S. 366 (1973). (Otter Tail Power Company prevented an independent municipal utility, which was surrounded by Otter Tail Power's franchise territory, from buying power from another potential supplier. It did so by refusing to transmit the power over Otter Tail Power's transmission lines, which were the only available transmission lines.)

(7) Although the DOJ/FTC Merger Guidelines provide a firm foundation for analyzing changes in prospective market power resulting from a proposed merger, the analysis does not focus on detecting or measuring market power that may already exist in the market. Further, antitrust enforcement is focused on anticompetitive mergers and unfair forms of competition. From an antitrust perspective, a firm that lawfully acquired market power does not commit an antitrust offense merely by exercising that power, unless it engages in unfair methods of competition to protect that power. Consequently, antitrust enforcement may not be able to reach such market power as a market moves from local regulated monopolies to competition. Hence, if the Task Force finds that horizontal market power problems exist in the generation market(s), it may wish to recommend that the Virginia Legislature (and State Corporation Commission) look beyond antitrust enforcement to considering a structural remedy (i.e., divestiture of generation assets by a transmission monopolist). At the same time, however, if the Task Force is contemplating recommending a structural remedy, such as divestiture, to correct an existing market power problem, an analysis of the remedy under the framework set forth in the DOJ/FTC Merger Guidelines may be useful because structural remedies, like mergers, involve a change in company or industry structure that is expected to have implications for market power. The Guidelines are designed to address changes in market power that result from structural changes.

(8) FERC's Inquiry Concerning the Commission's Policy on the Use of Computer Models in Merger Analysis; Notice of Request for Written Comments and Intent to Convene a Technical Conference, 63 Fed. Reg. 20,392 (1998) ("The purpose of this inquiry is to gain further input and insight into whether and how computer models should be used in the analysis of mergers ...").

(9) Federal Trade Commission, "Analysis of Proposed Consent Order to Aid Public Comment in In the Matter of PacifiCorp et al.," FTC File No. 971-0091, at 4 (February 18, 1998) (www.ftc.gov/os/9802/index.htm). (The FTC withdrew from the proposed consent order as of June 30, 1998 (www.ftc.gov/opa/9807/petapp39.98.htm).)

(10) The competitive implications of market concentration are affected significantly by entry conditions. If entry is likely, timely, and sufficient to undermine efforts to exercise market power, then even high concentration may not have adverse implications for consumers. (See the DOJ/FTC Merger Guidelines, Section 3, for a discussion.)

(11) Future generation technology developments may include economical micro-generators that would further ease concerns about the minimum efficient scale of entry. See, for example, Stuart F. Brown, Here Come the Pint-Size Power Plants, Fortune 64C-64P (1996); Thomas R. Casten, Electricity Generation: Smaller Is Better, 8 Elect. J. 65-72 (1995); and Clyde Wayne Crews, Jr., Electric Utility Reform: The Free Market Alternative to Mandatory Open Access, Competitive Enterprise Institute at www.electricity-online.com/crews.html (1998).

(12) At present, most residential consumers have few incentives to curtail consumption during peak usage periods when generation and transmission costs are highest because retail rates do not reflect these cost conditions and there is no way to distinguish consumption in peak hours from consumption in off-peak hours. Time-of-day metering will provide more consumers with more accurate signals of the cost of providing service and will allow consumers for the first time to change their patterns of electricity use to reduce their electricity bills.

(13) See NEPOOL Comment, supra note 2. The concerns expressed in the NEPOOL Comment were generalized in our May 1, 1998 ISO Policy Comment to FERC.

(14) Under traditional FERC transmission tariffs, an additional charge is incurred any time the contract transmission path involves more than one firm's transmission system, thus causing rates to be pancaked.

(15) 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.

(16) 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. For example, if the concern is that the ISO may favor restrictions on transmission, compensation for ISO managers could be designed to increase as transmission activity increases.

(17) Additional guidelines on formation of ISOs have been issued by FERC in Order No. 888, FERC 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, FERC Stats. & Regs. (CCH) ¶31,594 (April 24, 1996) (Open Access Same-Time Information System and Standards of Conduct).

(18) 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.

(19) Recent Administration 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)).

(20) 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).

(21) "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.

(22) A variety of