

UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Market-Based Rates for Public Utilities:
Technical Conference on Generation
Market Power and Affiliate Abuse
Issues

Docket No. RM04-7-000

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ON BEHALF OF
AMERICAN PUBLIC POWER ASSOCIATION AND
TRANSMISSION ACCESS POLICY STUDY GROUP**

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The American Public Power Association (“APPA”) and the Transmission Access Policy Study Group (“TAPS”) appreciate the opportunity to appear today to address the generation market power prong of the Commission’s market-based rate (“MBR”) test. The Commission has come a long way from the hub-and-spoke days, and we support the Commission’s efforts to examine market power issues and to develop market power tests that fulfill its statutory obligations. Recent technical conferences, where the Commission has heard a consistent refrain about the subtle and not so subtle ways market power can be exercised to render wholesale rates unjust and unreasonable, justify these efforts.

While today’s conference focuses on the generation market power prong of the MBR test, the Commission must not look at this prong in isolation. The issue in MBR cases is not simply whether the applicant has generation market power, but whether the seller’s market-based rates will be just and reasonable. All four prongs of the MBR test bear on each other and, of course, on the ultimate question of the lawfulness of market-based rates. For example, the extent of the applicant’s generation market power can depend, in part, on its exercise of transmission market power. A constrained transmission

system can prevent competing suppliers from challenging the applicant's generation dominance. A weak transmission system acts as a barrier to entry by hindering the siting of new generation. The applicant's ability to protect its own generation from competition through the maintenance of transmission constraints facilitates its preference for its affiliates' generation. Because of the connections among the four prongs, the Commission's Section 206 investigations of MBR authorizations should not be limited to the generation market power prong alone, but should instead examine all issues bearing on the lawfulness of market-based rates.

I realize that some sellers have complained to the Commission that the two interim generation market power screens now in place are flawed. APPA and TAPS have our own problems with the screens, including the fact that generation that clearly competes in wholesale markets is not considered in the analysis due to the use of the Uncommitted Capacity measure. But if you step back and look at the public utilities for whom the Commission ordered Section 206 investigations, one should not be surprised by the list. One does not think: "There's no way in the world these firms could be dominant, even in their control areas." Rather, it is entirely appropriate for the Commission to take a closer look to determine whether the market-based rates these public utilities charge are just and reasonable. Billions of consumer dollars are at stake. The resources expended examining the lawfulness of these rates pales compared to the potential overpayments consumers must make if these companies can successfully exercise market power. Just as in the days of cost-based rates, the Commission has an obligation to delve in and investigate where market-based rates have not been shown to be just and reasonable.

Last February, APPA and TAPS proposed in comments to the Commission a practical generation market power test with filing requirements calibrated for the market power potential of applicants.¹ The test is designed to yield relevant, probative and substantial evidence that can be used to assess market power, while minimizing the potential for false negatives and false positives. The test includes Horizontal Market Power Screens for nearly all applicants as well as an examination of what we call “Effects Factors” for dominant firms. The purpose of the Effects Factors is to give applicants and intervenors the opportunity to go beyond the screens to examine whether and how factors such as the Applicant’s control over transmission or its native load obligations affect an applicant’s ability and incentive to exercise market power. For example, the blunt elimination of native load obligations through the Uncommitted Capacity calculation can mask incentives that retail rate regulation gives sellers to raise wholesale prices. Our proposal also includes suggestions for how the Commission could manage its ongoing market rate reviews to facilitate the availability of information, such as on transmission capacity, and to address factual issues common to multiple applicants. Among other things, we propose conducting simultaneous reviews of MBR authorizations of members of the same corporate family. We also suggest ways the Commission could beef up its analytical infrastructure. Finally, and importantly, we recommend structural and cost-based rate remedies to mitigate generation market power.

We will re-submit our full proposal as part of our follow-up comments to today’s conference. In the time remaining, however, I’d like to address certain aspects of our

¹ See Post-Technical Conference Comments of the American Public Power Association and the Transmission Access Policy Study Group, available at <http://elibrary.ferc.gov/idmws/common/OpenNat.asp?fileID=10057963>.

proposal, propose a refinement of it, and come to the defense of the Market Share Screen. I'll start with the Market Share Screen.

As the Commission has correctly recognized, its screens cannot be determinative. While providing evidence bearing on the question of market power, the screens are generally too crude as tools to be conclusive. Rather, when the screens suggest a problem, the Commission should take a closer look. We also worry about cases where applicants pass the screens but nonetheless have the ability and incentive to exercise market power. For this reason, we oppose making the 20% threshold an irrebuttable presumption, if that is what is meant by a bright-line test. For example, a seller with a dominant position in marginal capacity that can set the market clearing price and has inframarginal capacity has different incentives and opportunities compared to a seller with only inframarginal capacity. For this reason, we support incorporating an analysis of supply curves into the MBR test, as described in APPA and TAPS's prior comments.

We strongly disagree with those who would ditch the Market Share Screen or suck the meaning out of it by using what has been called "contestable load" or "truncated market share" analysis. As we understand this approach, one defines the size of the market by the amount of wholesale load that is deemed "contestable." If a seller's generation capacity amounts to more than the contestable load, the method calls for capping that seller's capacity at the contestable load level for purposes of determining market shares.

One evident problem with such a contestable load or truncated market share analysis is that it ignores the competitive capability provided by the generation fleets of large electric power sellers, especially ones that operate their own transmission control

areas. These fleets make an enormous difference to these firms' ability to compete and to influence prices. For example, such fleets enable the dominant sellers to bid on a wider variety of products, whether load-following type contracts or firm capacity sales.² Sellers with these capabilities can economically add a new 25 MW wholesale load (backed by reserves) to its existing load obligations, providing both firm power and load-following type services. By contrast, if an IPP has just a single plant, it may have trouble "firming up" the sale to ensure deliveries at times of plant outages. Further, although an IPP with a single, 1000 MW combined cycle plant might be able to make a 25 MW unit capacity sale, it often can't even do that unless it has an "anchor tenant" to purchase the bulk of its output. The 25 MW sale will not be a viable option. The IPP is also unlikely to be in a position to provide a load-following type service and is subject to energy imbalance penalties that the dominant seller with its own control area doesn't have to worry about.

The contestable load or truncated market share analysis ignores these important differences, and the differences do matter. Section 1.41 of the Horizontal Merger Guidelines, which has been cited as support for this approach, contemplates assigning equal market shares to firms that have, on a forward-looking basis, an equal likelihood of securing sales. One market where this provision of the Guidelines is relied upon is

²These combined merchant and rate base fleets together support wholesale marketing activities. According to The Cruthirds Report, Southern Company reported that "it earned about \$220 million from its 'competitive generation' business in 2004 - \$111 million from Southern Power's generation (unregulated affiliate — a large percentage of those sales are to Southern Company regulated utility affiliates resulting from questionably managed RFPs) and \$109 million from Southern's 'embedded' (rate based) generation. Southern projected profits of \$200 million from the competitive generation business for 2005 - \$90 million from Southern Power and \$100 million from the embedded generation. Southern earned about \$53 million in "opportunity sales" (trading floor profits) during 2004, but is only projecting earnings of \$35-38 million during 2005. The other \$166 million expected to be earned by the competitive generation business in 2005 is attributable to capacity payments under long-term PPAs." See "Special Report: Southern Company Conference Call - 4th Quarter 2004 Financial Results," The Cruthirds Report, January 26, 2004, available at <http://www.thecruthirdsreport.com>.

school milk. We're all familiar with school milk. School systems seek bids to supply their milk needs. However, schools are not grocery stores and thus lack large amounts of refrigerated storage. Schools also want fresh milk. These requirements mean that dairies bidding for school milk contracts must have the capability to deliver fresh school milk on a regular basis, which generally necessitates access to dairy farms, possession of a delivery network and proximity to the school system served. Competitive analysis of school milk markets involves determining which dairies are in a position to serve the school systems' needs. When determining market shares, the antitrust agencies assign an equal market share to each dairy that has the capability and therefore can bid on and win these contracts. These dairies' other capabilities are less important, so long as the dairies can satisfy the school milk requirements.

As should be evident, electricity markets are not school milk markets. Contestable load and truncated market share analysis assumes that competitors are similarly situated, with an equal ability to supply the needed product, when in reality they are not. The competitors don't have the dominant firm's route system -- its transmission system; they don't have the similar resources -- the firm's fleet of merchant and rate base generation. Because the approach artificially reduces the market share of the dominant firms and masks their true competitive advantages, it is not a meaningful test for purposes of determining the lawfulness of market-based electricity rates. Indeed, it turns the notion of "leveling the playing field" on its head -- shrinking down the dominant player so that it looks like it's a member of the competitive fringe.

One possible, meaningful refinement to the Commission's screens would be to examine capacity that is available to compete in short-term markets separately from

capacity that can compete in long-term markets. For example, capacity that at times serves native load but at other times is available to bid into the spot market should be counted when assessing short-term markets. On the other hand, if such capacity would not be bid to satisfy a new long-term contract, it may not be appropriate to include it as available to compete in long-term markets. Entry analysis also differs depending upon whether the market of interest is the short term or long term. In the short term, new generation entry cannot be relied upon to defeat market power exercise, because of the amount of time needed to site and construct new generation. In the long term, entry conditions need to be examined to determine whether barriers to entry, such as the difficulties in ensuring timely construction of new transmission, securing fuel or locating a site not owned by the dominant firm, support entry that is timely, likely and sufficient to address market power concerns. The Commission shouldn't simply assume that entry will occur.³

Another part of the competitive analysis that should not be assumed is transmission availability. The transmission capacity figures used in the MBR analysis must reflect transmission available in fact. One thousand megawatts of simultaneous import capability at the MBR Applicant's transmission interfaces is a meaningless number if a wholesale customer embedded within a transmission provider's control area needs a firm path to purchase from a competitive supplier, but cannot secure such a path on a timely, economic basis. As the Commission heard from TAPS witness Anne

³ Self-build may not be an option for wholesale customers, as the Commission recognized its April MBR Order: "there are a number of reasons why market participants do not have the option of building capacity at a competitive cost, including lumpy generation investment, insufficient transmission access, and insufficient access to fuels. Further, depending upon the facts and circumstances, a new generating facility is not always a comparable or feasible alternative to a long-term purchase." *AEP Power Mktg, Inc.*, 107

Kimber last month, the reality of transmission access often differs from what is shown to be available on paper.

The Commission's chosen geographic market definitions must also reflect reality, especially when constraints prevent competing supplies from reaching a market, including load pockets. The Commission should not simply assume that a control area or an RTO footprint is the relevant geographic market. Even within ISO/RTO regions, transmission constraints separate load pockets from the rest of an RTO region.⁴ The Commission's orders announcing the Interim Screens seemed to recognize this in making the geographic market definition a rebuttable presumption. Recent applications of the Interim Screens unfortunately suggest otherwise. Proper geographic market definition should not pretend that such a load pocket is part of the larger market.

Where market power is found, the Commission must remedy or mitigate it; otherwise it cannot approve market-based rates. In RTO regions, the Commission has indicated a willingness to conclude without any case-by-case examination that RTO market mitigation suffices to address the generation market power of MBR applicants. We do not believe that these mitigation regimes, while intended to ensure the proper functioning of RTO spot markets, are sufficient to mitigate market power found to exist through the MBR review process. First, the RTO mitigation measures are crafted on a generic, RTO-wide basis, and have not been shown to address the market power risks posed by specific MBR applicants. Second, most of the thresholds used to assess seller bidding have a high tolerance for market power exercise. Consider that consumers suffer

F.E.R.C. ¶ 61,018, P 155 (2004).

⁴ It defies reality to claim that load pockets such as New York City, Long Island or Southwest Connecticut

competitive harm from sustained price increases of only a few percentage points. However, under Commission-approved market mitigation, such anticompetitive price increases fall under the radar screen of market monitors. Indeed, in some cases price increases of up to 200% or \$100/MWh are tolerated before mitigation is even considered. That's a lot of unmitigated market power. A mitigation measure that permits such harm should not be "deemed" to have mitigated the market power of a seller asking for MBR authority, at least without close examination of the specific case. If the Commission fails to carry out such an examination, it will be subject to legal attack on the grounds that it has not fulfilled its FPA obligations to ensure on a continuing basis that wholesale rates are just and reasonable.⁵

What are effective remedies? We note that the question deserves its own technical conference, focusing not just on remedies for generation market power, but remedies addressing all prongs of the MBR analysis to ensure that market-based rates, where authorized, are just and reasonable.

Denial of market-based rate authority must be one remedy, as well as imposing obligations on the failing Applicant to offer to sell wholesale power at cost-based rates, especially where wholesale consumers do not have sufficient access to alternative power supplies. For organized spot markets, there's no reason why a bid reflecting the Applicant's marginal costs cannot be submitted, consistent with the theory supporting the use of such markets.⁶

do not represent separate geographic markets.

⁵ *Cal. ex rel. Lockyer v. FERC*, 383 F.3d 1006 (9th Cir. 2004).

⁶ The bids of energy and emission-limited resources may properly reflect the opportunity costs of using those resources during one time period versus a later period.

The denial of market-based rates authority should extend to sales beyond the Applicant's control area if constrained transmission isolates buyers embedded in the Applicant's control area from the larger regional market. Not only are these trapped customers discriminatorily denied access to the larger market, that market is distorted because demand is artificially suppressed.

These are not abstract concerns. A transmission provider with generation market power might conclude neither to construct the transmission necessary to mitigate transmission constraints nor to make wholesale sales at cost-based rates in its own control area. For example, if the transmission provider can export power from its transmission system, it might choose to make sales at market-based rates in neighboring control areas, and simply make no sales, at any price, to wholesale customers in its own control area. This result, however, would be untenable for those wholesale customers located in the transmission provider's transmission-constrained control area. They would not have access to competitively priced power supplies as a result of such transmission constraints, and the incumbent supplier would not sell to them. If the transmission provider also competes with the wholesale customers on its system for end use loads (as is indeed the case in many instances), anticompetitive concerns, including price/supply squeeze issues, are also raised.

Other remedies should focus on structural changes that remove the ability and incentive for sellers to exercise market power. Such remedies should be targeted and tailored to address the market power problems identified for a specific applicant. Depending on the market power problem to be address, appropriate remedial conditions on market-based rate authorizations could include:

- Reducing the applicant's size in the market. This can be achieved without divestitures. For example, the seller could sell or auction capacity entitlements, turning over control of that capacity to competing suppliers.
- Facilitating diversification of ownership of generation in a market to increase the number of competitors. The seller could offer LSEs and others opportunities to participate in ownership of new generation and transmission facilities.
- Expanding transmission capacity available to access alternative suppliers.
 - Capacity can be made available without expanding the grid by, for example: (1) the transmission provider's setting aside transmission capacity for use by customers in the transmission provider's control area that have insufficient access to regional markets due to transmission constraints; and (2) clarifying and strengthening network customer roll-over rights to allow network transmission customers a realistic ability to change network generation resources.
 - Expanding the grid by for example: (1) making identified transmission upgrades, (2) adhering to the requirement that transmission owners plan and construct the transmission system to accommodate the network customers' existing and planned network resources; (3) obligating transmission owners to relieve constraints that impact or prevent access to competitive supply; and (4) encouraging joint ownership and regional planning of the transmission grid.

Once remedies are identified, the Commission should require a compliance process that ensures that the remedies are implemented. The Commission must also monitor the remedies to ensure they achieve the desired ends.