UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

Technical Conference on Public Utility Holding Company Act of 2005 and Federal Power Act Section 203 Issues	)))	Docket No. AD07-2-001

ORAL STATEMENT OF SUSAN N. KELLY
FOR MARCH 8 TECHNICAL CONFERENCE
ON BEHALF OF THE
AMERICAN PUBLIC POWER ASSOCIATION

Thank you very much for allowing me to represent the American Public Power Association ("APPA") at this important technical conference. As you know, APPA has had a long-standing interest in the Commission's policies for evaluating mergers of "public utilities" under Section 203 of the Federal Power Act ("FPA"). In January 1996, APPA jointly filed with the National Rural Electric Cooperative Association a petition in Docket Nos. PL96-1-000 and RM96-8-000, seeking to have the Commission review its then-existing merger standards. Soon after, the Commission opened a rulemaking proceeding to do just that, in which it issued Order Nos. 592, FERC Stats. and Regs. ¶ 31,044 (1996), and 592-A, 79 FERC ¶ 61,321 (1997). Those orders, together with the Commission's subsequent Order Nos. 642, 93 FERC ¶ 61,164 (2000), and 642-A, 94 FERC ¶ 61,289 (2001), laid out the so-called "Appendix A" analysis, with its Delivered Price Test ("DPT"), and the associated filing requirements that the Commission currently uses to evaluate public utility mergers under FPA Section 203.

Approximately 10 years have passed since Order Nos. 592 and 592-A. The landscape of the electric utility industry has changed substantially in that time, as the Commission itself has recognized. In its recent Order No. 890, issued on February 16, 2007, in Docket Nos. RM05-17-000, *et al.* (at PP 19–21), the Commission outlines some of the changes that have taken place in the industry since 1996. A wave of independent power generators and marketers entered the industry and constructed a fleet of natural-gas-powered electric generation. Many of those suppliers have now gone through bankruptcy, exited the industry entirely, sold their generation assets to incumbent public utilities, or handed their generation assets over to their lenders, vividly illustrating the high barriers to successful entry into wholesale electric generation markets. Approximately 25 states have implemented retail access, with many of them requiring their incumbent public utilities to divest some or all of their generation assets, which in many cases were purchased by unregulated affiliates of those public utilities, or by affiliates of other public utilities located in other regions of the country. Most of these retail-access states are in regions covered by the footprints of Independent System Operators ("ISOs")/Regional Transmission Organizations ("RTOs"), which operate centralized wholesale markets for day-ahead and spot energy and ancillary services using locational marginal pricing, and some of which are implementing locational capacity markets.

The regulatory landscape has changed radically as well. In 2005, Congress repealed the Public Utility Holding Company Act of 1935 ("PUHCA"), eliminating Securities and Exchange Commission ("SEC") review of holding company mergers, and the associated "integration" requirement under PUHCA. Interestingly enough, state public utility commissions seem to have stepped up their own reviews of public utility mergers in the wake of PUHCA repeal, although it is difficult to ascertain if there is an underlying cause-effect relationship, or whether this will continue. Congress in 2005 also amended FPA Section 203, adding an explicit requirement that the Commission consider cross-subsidization issues when analyzing a proposed merger, and giving it jurisdiction over the acquisition of generation assets used to make wholesale sales.

Given all of these intervening events, APPA believes it is appropriate for the Commission to re-examine its current merger evaluation policies under FPA Section 203, which is why this conference is so timely. With these thoughts in mind, APPA responds to the questions posed to this panel. In doing so, I hasten to add that while I am a long-time regulatory lawyer practicing before this Commission, I am not an economist or an antitrust lawyer, and I do not hold myself out to be an expert on antitrust law or merger policy. I defer on such matters to Professor Bush, Dr. Frankena, and Dr. Moss.

In light of recent industry and regulatory changes in the electric utility industry, is Appendix A effective in measuring the effect on competition of "long-distance" mergers (*i.e.,* where applicant systems are not contiguous)?

The long-run implications of PUHCA repeal on the structure of the electric utility industry will likely not be known for some years. Because of the "integration" requirement imposed on mergers of registered holding companies, PUHCA (at least when it was fully enforced) discouraged "long-distance" mergers. This was the case when the Commission adopted its Appendix A analysis. Hence, such geographically distant merger proposals were much less likely to be filed with FERC in the first place, because they would have to also be filed with the SEC, and would have to meet the integration requirement.

In the last few years prior to PUHCA's repeal, however, we saw a wave of "long-distance" utility merger proposals, such as American Electric Power ("AEP")-Central and Southwest ("CSW"), Duke-Cinergy, Mid-American-Pacificorp, and Constellation-Florida Power and Light ("FP&L"). Duke-Cinergy and Mid-American-Pacificorp easily passed muster under the Commission's application of Appendix A, without any trial-type hearing;

only one (AEP-CSW) was fully considered by the SEC under PUHCA. Only the fourth merger (Constellation-FP&L) was not consummated, and that was due to state-level issues, not Appendix A concerns (in fact, the Commission never officially considered that proposed merger). Now that PUHCA is officially "off the books," we could easily see more of such long-distance mergers.

APPA believes that 'long distance" mergers raise unique competitive concerns that the Appendix A analysis, as it has been applied, by itself does not capture. One concern is the "forgone competition" between potential competitors, even where those entities are not currently strong competitors in overlapping markets. The Federal Trade Commission raised this concern in the Order No. 642 proceeding, urging the Commission to take into account the possibility of slower entry into new markets as a result of a proposed merger. Even if a regulated public utility operates in a single unified footprint, it is likely to have unregulated generation/marketing affiliates that operate in many other markets. If two such geographically distant public utilities merge, it makes it less likely that their unregulated affiliates will compete against each other in either utility's "home" market, or that both will enter a third one. Nonetheless, under Order No. 642, an applicant need not provide a full competitive-analysis screen if it demonstrates that the merging entities do not currently operate in the same geographic markets, and no intervenor alleges that one of the merging entities is a perceived potential competitor in the other's geographic market.

Moreover, APPA believes that the Commission should examine the increased risks of collusion or oligopolistic pricing that may arise where the same reduced sets of competitors meet each other in multiple regional markets, especially RTO-run centralized markets, with their repeated auctions and hence repeated opportunities for interaction and observation among competitors.

Is Appendix A effective in measuring the effect of competition in mergers that involve applicants in RTO markets?

Appendix A relies nearly exclusively on concentration analysis. APPA is quite concerned that concentration measures alone, such as the Herfindahl-Hirschman Index ("HHI"), are not adequate to analyze competition in electricity markets. Concentration measures may not reveal merger harms associated with the potential for market-power exercise even where the merged firm's market share is below what would typically be deemed troublesome. Some academic studies seem to indicate that under a centralized RTO day-ahead/real-time market structure, it is possible for bidders with relatively small market shares to influence price outcomes, and for bidders to engage in "repeated games" that can maximize their profits at the expense of consumers.[1] APPA is also concerned that the Commission does not examine competitive effects on all wholesale power products, including short-term, long-term, bilateral, organized, energy, capacity and ancillary services, even though Appendix A allows differentiation of product markets. Since many of our members are net buyers of generation, with a need for load-following power supply products, their needs often cannot be met by "standard" power products, such as blocks of power. This reduces the universe of suppliers that can serve them, and makes them even more concerned when public utilities propose to merge.

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1 Comments of Jay Apt, Lester Lave, and Seth Blumsack for Carnegie-Mellon University's Electricity Industry Center filed in FERC Docket No. AD05-17-000 on November 18, 2005, at 8–12 and especially 9 ("Unlike in other industries, market power in electricity auctions has relatively little to do with market shares.").

Is Appendix A adequate to consider the effects associated with generation-only mergers and acquisitions, now subject to Commission jurisdiction as a result of EPAct 2005?

APPA is concerned that Appendix A may not sufficiently take into account more recent industry trends in generation facility acquisitions. Due to the financial distress of many of the new generation entrants, many of their projects have changed hands multiple times, some ending up in the hands of major financial players, while others have been acquired by incumbent public utilities. Many of these individual transactions are relatively small when compared to the "mega-mergers" the Commission considers, but taken together, they could be the "death of a thousand cuts" to a competitive generation market. Since the Commission now has explicit authority over generation acquisitions, it should carefully review its Appendix A analysis to ensure it is employing its new authorities to best effect.

Are any changes needed regarding how Appendix A accounts for transmission constraints in RTO and non-RTO regions?

Commission practice under Appendix A recognizes the role of transmission constraints in market definition, in contrast to the current practice under the Commission's market-based rate ("MBR") screens, especially in RTO/ISO footprints. But the extent to which transmission constraints are actually taken into account in an Appendix A analysis depends in substantial part on the applicants seeking approval of a merger. They are the entities that develop the Appendix A analysis and file it with the Commission. If they choose not to take a transmission constraint into account in developing the relevant markets, then it is up to intervenors to point this out, and to argue for more recognition of such constraints.

I would like to close by suggesting some other lines of inquiry for the Commission as it reviews its current merger evaluation standards and policies. Do those policies sufficiently evaluate the competitive implications of more traditional "side-by-side" public utility mergers? The Commission's Appendix A analysis is based in substantial part on the Department of Justice's ("DOJ") Horizontal Merger Guidelines, yet the Commission and DOJ have in some cases reached different conclusions as to the competitive implications of the same merger. And certain states have taken an even more activist approach to such mergers than either DOJ or the Commission. Why are these various agencies/entities seeing the same merger differently? Would better coordination and information exchange among these agencies improve their respective analyses? Should the Commission enhance its internal capabilities to analyze the potential impact of proposed mergers on regional electric markets by developing its own regional market models?

Is the Commission considering the potential long-term effects of the new kinds of players entering the industry, such as financial institutions with substantial trading books, private equity firms, and hedge funds? PUHCA's limitation on other lines of businesses that holding companies could engage in discouraged such entities from entering the industry in the past, but PUHCA is gone, and these new players are now on the scene. Since the Commission uses a broader "consistent with the public interest" standard to evaluate mergers, should it be looking at applicants' profit-making strategies and business plans, and seeking to protect ratepayers from the adverse consequences of "strip and flip" and other such strategies?

Should the Commission consider better coordinating its market-based rate and merger policies and determinations? At present, there are separate inquiries regarding mergers and market-based rate authorizations, although the applicant can submit a DPT analysis if it does not pass the market-share and pivotal-supplier screens. If an incumbent public utility is unable to obtain MBR authority for its own control area due to its generation dominance, or is required to implement substantial mitigation in order to obtain such authority, should that fact be considered if it subsequently seeks to merge with another public utility, especially one in an adjacent control area or in the same region?

Should the Commission consider expanding its "toolbox" of possible conditions on merger approvals to mitigate the potential exercise of generation and/or transmission market power? Such additional remedies could include the offering of joint ownership in the merger applicants' existing transmission facilities to other Load-Serving Entities ("LSEs") located in the merger applicants' control areas, and participation opportunities on reasonable terms for such LSEs in new transmission and generation projects the applicants might undertake. While these might seem radical proposals today, conditioning merger approval on the provision of open access transmission service once seemed radical too.

I want to close by emphasizing that the Commission is the only federal agency that has as a core mission the regulation of wholesale electric power supply markets, and, in particular, guarding consumers from exploitation by non-competitive electric power companies. This mission is critical to the Commission's consideration of mergers and acquisitions under FPA 203. If the Commission allows wholesale electric power markets to be undermined by endemic market structure problems, then it will no longer be able to rely on competition to discipline wholesale rates to just and reasonable levels. That in turn will bring on a whole host of other regulatory problems. This is truly an area in which an ounce of prevention is better than a pound of cure.

I appreciate the opportunity to speak to you today, and look forward to your questions.