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

BEFORE THE FEDERAL ENERGY REGULATORY COMMISSION DEPARTMENT OF ENERGY WASHINGTON, D.C.

In The Matter of New England Power Pool

Docket Nos. ER97-237-000 and ER97-1079-000

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

February 6, 1998

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission ("FTC")(2) appreciates this opportunity to respond to the Federal Energy Regulatory Commission's ("FERC's") Notice of Filing concerning market power monitoring and mitigation by the New England Power Pool ("NEPOOL") independent system operator, ISO New England, Inc.(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, 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.(4) Moreover, the FTC regularly reviews proposed mergers involving electric and gas utility companies.

To further the advance of competition, FERC has adopted rules that call for utilities to offer open, non-discriminatory access to wholesale transmission services.(5) Our Open Access Comment in that proceeding expressed concerns that (1) behavioral constraints do not remove incentives to discriminate in transmission decisions and (2) violations may prove difficult to detect.(6) We recommended consideration of operational unbundling, which would separate operation of, and access to, the transmission grid from economic interests in generation, as an alternative to behavioral rules against discriminatory access. Subsequently, FERC has approved two independent system operators ("ISOs"), which incorporate an operational unbundling approach similar to what we had advocated.

Within the context of considering an additional ISO, ISO New England, Inc., and the request for market-based rates filed by NEPOOL, FERC now entertains NEPOOL's proposal to deal with potential horizontal market power stemming from generator dominance. NEPOOL proposes a system employing behavioral monitoring by ISO New England and relying exclusively on behavioral remedies, rather than a restructuring of generation assets, if a market power problem is detected at the generation level.(7)

We believe that the potential difficulties in detecting market power and in preventing its exercise through behavioral rules identified in our previous comment also apply here. Consequently, as FERC considers this and similar proposals for forming ISOs or restructuring power pools into ISOs, it may wish to consider carefully the use of structural remedies instead of or in addition to behavioral solutions.

We take no position as to whether market power is present in the generation market or markets at issue in this proceeding. However, if FERC finds generator dominance in an initial market power assessment in this proceeding, or if ISO New England detects generator market power through its monitoring of operations, FERC may wish to consider structural remedies in order to increase the likelihood of effective competition in New England. Further, to the extent that structural remedies are not initially adopted, FERC may wish to establish a date for a subsequent evaluation of whether there is a need for structural remedies.(8)

II. Restructuring May Complement Behavioral Monitoring and Mitigation in Ameliorating Horizontal Market Power in Generation

In our Open Access Comment we discussed two basic difficulties with taking a solely behavioral approach to market power in the electric industry. One of the concerns was the difficulty of detecting the exercise of market power. Specifically, we observed that monitoring and mitigation through behavioral regulations could require virtually transaction-by-transaction oversight and likely would be particularly difficult when transactions are highly time sensitive, as they are in electric power.(9)

We believe that much the same problem is likely to exist in detecting the exercise of horizontal generation market power. Because of the need to balance supply and demand continuously in the electric industry, hour-by-hour or even half-hour by half-hour product markets are relevant, and geographic markets fluctuate with transmission congestion conditions on this same basis. Within this context, subtle bidding and generation availability decisions can have marked effects in raising prices and reducing output, and it could be very difficult to determine and document that these actions are anticompetitive. In addition, there is the risk that competitive behavior will be misidentified as anticompetitive behavior, thus chilling competition and increasing administrative and litigation costs. For these reasons, although market power monitoring and behavioral mitigation of market power may be useful, they are unlikely to be a fully effective substitute for restructuring, if prospects for generation dominance are present.(10)

III. Restructuring May Be a Preferable Remedy for Market Power

A second basic difficulty addressed by our Open Access Comment was that a solely behavioral approach to transmission access issues would leave in place any existing incentives to exercise market power.(11) A similar concern may arise here: if market power is present in power generation (and we express no views here on that factual question), the incentives for its exercise would remain under a behavioral approach to monitoring and mitigation.

The plan under consideration by FERC proposes that in the event the ISO detects market power, the ISO may mitigate that market power by applying behavioral constraints. The plan does not include an option for restructuring the generation market as a remedy for market power. If FERC finds evidence of generation market power at the present time, however, it may wish to consider making appropriate structural relief a predicate for granting the authority sought in these proceedings. In the alternative, if FERC does not make a finding of current generation market power, then FERC may wish to condition any initial grant of authority in these proceedings in ways that allow for review of the monitoring experience of the ISO after a certain time and that would enable FERC to require any necessary structural remedies before the initial authority is extended.

From a historical perspective, we note that in the United Kingdom, generation dominance leading to market power persisted for some time before the reviewing authority identified it as a problem requiring mitigation.(12) Further, when remedial options were reviewed, restructuring, rather than an additional set of behavioral constraints, was identified as the most effective remedy.(13)

Respectfully submitted,

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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.

2. 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).

3. 63 Fed. Reg. 1965 (January 13, 1998).

4. The staff of the FTC has commented on electric power regulation to FERC in Docket No. RM96-6-000 (May 7, 1996), Docket Nos. RM95-8-000 and RM94-7-001 (August 7, 1995) ("Open Access Comment"), and Docket No. RM85-1-000 (1985); to the California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032 (August 23, 1995); and to the South Carolina Legislative Audit Council (February 28, 1994). In addition, the staff of the FTC has commented to FERC about natural gas regulation. See comments about pipeline regulation after partial wellhead decontrol, Docket No. RM85-1-000 (1985); alleged anticompetitive practices of pipeline marketing affiliates, Docket No. RM87-5-000 (1987); and capacity brokering, Docket No. RM88-13-000 (1988).

5. FERC Order 888, In the Matter of Promoting Wholesale Competition Through Open Access Services by Public Utilities and Recovery of Stranded Costs by Public Utilities and Transmitting Utilities, Docket Nos. RM95-8-000 and RM94-7-001 (April 24, 1996).

6. Open Access Comment at 7-13. In Order 888, at Section IV.A.2, FERC acknowledged the seriousness of these concerns:

As a further precaution against discriminatory behavior, we will continue to monitor electricity markets to ensure that functional unbundling adequately protects transmission customers. At the same time, we will analyze all alternative proposals, including formation of ISOs, and, if it becomes apparent that functional unbundling is inadequate or unworkable in assuring non-discriminatory open access transmission, we will reevaluate our position and decide whether other mechanisms, such as ISOs, should be required.

7. The proposal calls for ISO New England to focus its market power monitoring resources on instances where a generator is withholding output, raising bids on resources that set the clearing price, or engaging in other anomalous behavior. Market power mitigation options include changes in ISO New England's operating rules, voluntary establishment of the bid formula for a particular generator or delegation of the bidding authority to a third party, higher reserve requirements, substitution of default bids at prices determined under pre-established rules, mandatory short-term restrictions on bidding behavior, and various sanctions. A review and appeals process is also specified. See ISO New England, "Market Monitoring, Reporting and Market Power Mitigation" (December 19, 1997).

8. This comment addresses only the issue of market power mitigation in generation. As suggested by our Open Access Comment, obtaining the full benefits of competition ultimately requires consideration of a variety of restructuring issues, such as the possibility of stranded costs. We express no views about the impact of such restructuring issues on the ultimate benefit of the NEPOOL proposal, including the likely magnitude of any stranded costs that may ensue upon approval of NEPOOL's application for market-based rates, or about the net costs and benefits of the various methods of stranded-cost recovery.

9. Open Access Comment at 8.

10. Restructuring itself may entail costs, but an assessment of the relative costs and benefits of restructuring is necessary before deciding which remedies, if any, afford the greatest net benefits.

11. Absent separation of the operation of transmission services from the ownership of generating plants, we explained, mandating equal access to the transmission grid required transmission operators to ignore their own economic interests and left incentives in place to find ways to evade regulatory constraints. Open Access Comment at 7-13.

12. The United Kingdom restructured its electrical system in March 1990. See Richard J. Green and David M. Newberry, "Competition in the British Electricity Spot Market," 100 J. Pol. Econ. 929 (1992), for a discussion of the extensive data and detailed statistical analyses used to establish the nature and extent of market power in the United Kingdom's system. In July 1993, the United Kingdom's Director General of Electricity Supply indicated that the extent of competition was not sufficient to restrain the exercise of market power by the two dominant generators. See Statement of the Director General of Electricity Supply, "Proposed Acquisition by Eastern Group PLC of 4,000MW of Plant from National Power PLC" at 2 (May 9, 1996).

13. Divestitures were completed in June 1996 to remedy the Director General's concerns. See Press Release of the Director General of Electricity Supply (June 25, 1996); Statement of the Director General of Electricity Supply, "Proposed Acquisition by Eastern Group PLC of 4,000MW of Plant from National Power PLC" (May 9, 1996).