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ELIMINATING MARKET POWER IN THE TRANSITION TO COMPETITION

Overview. The transition to a more competitive electric industry raises many important concerns with respect to market power. As regulated monopolies, electric utilities were allowed substantial market power, but subject to regulatory oversight. In the emerging restructured industry, services such as generation, billing, and metering are being deregulated and made subject to competitive forces. Other services such as transmission and distribution remain regulated because the underlying assets – the "wires"– are natural monopolies. This creates the anomalous situation in which corporate entities jointly own or control both regulated and unregulated business functions, creating a powerful incentive to abuse the market power of the regulated functions for the benefit of the unregulated functions.

In addition to this type of market power abuse, there is also the risk of horizontal concentration in the ownership of generation. This trend is now evident as the divestiture of generation by many utilities has created an unprecedented opportunity for asset consolidation. While consolidation is not bad, *per se*, it is happening before transmission bottlenecks are removed which would allow broader, regional generation markets to prevent the exercise of market power by these larger generation companies.

This *Profile* examines the potential for market power in the transition to a more competitive industry and recommends structural, behavioral, and legislative remedies for eliminating or mitigating the market power. These remedies are essential preconditions for the creation of real competition in the electric industry where competition can exist. Markets cannot make these changes if the requisite markets do not first exist. Policy makers–both regulatory and legislative–bear the responsibility for ensuring that these preconditions are put in place.

PROFILES ON ELECTRICITY ISSUES are published to promote a better understanding of the economic and social impacts of policy proposals relating to electricity. ELCON members seek an adequate and reliable supply of electricity at competitive prices, not only for the benefit of industrial consumers and their labor force, but also for all consumers of industrial products and the U.S. economy.

Profiles on Electricity Issues

ELIMINATING MARKET POWER IN THE TRANSITION TO COMPETITION

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SUMMARY OF ELCON'S RECOMMENDATIONS FOR ELIMINATING MARKET POWER IN THE TRANSITION TO COMPETITION

State and federal policy makers should act to eliminate or mitigate market power before, or at the same time as, electric industry restructuring plans are implemented. Preference should be given to **STRUCTURAL REMEDIES** for eliminating market power. These remedies should be a precondition to state restructuring initiatives because, absent these structural reforms, real competition will not emerge. One-time structural remedies also do not require continued regulatory oversight and remove government from decisions better made by markets. However, strong **BEHAVIORAL REMEDIES** must also be used if utilities are allowed to jointly own or control regulated and unregulated affiliates within a holding company structure.

The Federal Power Act and state public service laws never anticipated the advent of retail competition, and therefore, additional **LEGISLATIVE REMEDIES** are necessary. Congress should clarify and expand the authorities of state and federal regulators to adequately address market power concerns both in the transition to a new competitive industry and after the transition. History has demonstrated that markets do not operate efficiently without set rules and bounds.

STRUCTURAL REMEDIES

Certain necessary conditions must be in place before the transition to a competitive industry is allowed to start. Failure to do this may only enhance the market power of incumbent utilities and prevent real competition from evolving. The necessary conditions are predominantly structural in nature. This fact is worth repeating. Structural remedies remove entry barriers to new market participants and innovators. The following structural remedies are strongly recommended:

- Operationally Separate Generation, Transmission, Local Distribution, and Marketing Functions
- Require Membership in an Independent Regional Transmission Organization by All Transmission Owners
- Strong Antitrust Review of New Mergers and Acquisitions to Limit Horizontal Concentration in the Ownership of Generation Before Transmission Bottlenecks Can Be Removed
- Unbundle All Competitive Products and Services From Regulated Services
- Impose Structural Reforms as a Precondition to Stranded Cost Recovery
- Mandate Nondiscriminatory Access to Transmission Reservation and Scheduling Services
- Avoid Artificial Impediments to Retail Competition Such as the Offering of Inappropriately Designed Default Services or Subsidized Standard Offer Services

BEHAVIORAL REMEDIES

All market power cannot be eliminated because of the manner in which the industry was allowed to evolve in the past. This is particularly true with respect to the joint ownership of regulated and unregulated utility functions. This structure will likely persist. Therefore, strong behavioral remedies are necessary to mitigate this residual market power. Behavioral remedies will be successful—in the longer term—if the market discourages the continued joint ownership of regulated and unregulated business functions. The market may judge that the coexistence of such business functions is inherently inefficient and not in the best interests of shareholders. The following behavioral remedies are recommended:

- Increase Antitrust Enforcement Commensurate with the Pace of Deregulation
- Prohibit Stranded Cost Recovery Mechanisms That Act as Barriers to Competition
- Mitigate Discriminatory and Other Anticompetitive Behaviors with "Codes of Conduct"

LEGISLATIVE REMEDIES

Existing federal and state consumer protection laws never anticipated the restructuring of the electric industry, particularly at the retail level. Federal and state regulators will need limited new authorities to impose additional structural and behavioral remedies necessary to eliminate or mitigate market power. These include:

- Enact Regulatory Reforms to Complement the Minimum Needs of a New Industry Structure
- Ensure Adequate Access to Books and Records by State and Federal Agencies Necessary to Monitor Inter-Affiliate Transactions
- Clarify the Authorities of FTC and DOJ to Review Electric Utility Mergers
- Establish Separate and Independent North American Reliability and Commercial Practices Standards-Setting Organizations
- Repeal PUHCA and PURPA Only After Competitive Markets Have Been Formed

The transition to a more competitive electric industry creates new opportunities for the exercise of market power because of the joint ownership of regulated and unregulated business functions. In addition, existing transmission bottlenecks increase the risk of horizontal concentration in the ownership of generation as the generation markets undergo rapid consolidation. A truly competitive industry will not emerge absent elimination or effective, ongoing mitigation of the various forms of market power. Structural remedies are the most efficient means of eliminating market power. But behavioral remedies will also be needed until the capital markets discourage joint ownership. New consumer protections laws are also needed to complement the new industry structure and to ensure that all consumers benefit from competition. These remedies are essential preconditions for the creation of real competition in the electric industry. Markets cannot make these changes if the requisite markets do not first exist. Policy makers—both regulatory and legislative—bear the responsibility for ensuring that these preconditions are put in place.

Profiles on Electricity Issues

ELIMINATING MARKET POWER IN THE TRANSITION TO COMPETITION

INTRODUCTION

The transition to a more competitive electric industry raises many important concerns with respect to market power. As regulated monopolies, electric utilities were allowed substantial market power, but subject to regulatory oversight. In the emerging restructured industry, services such as generation, billing, and metering are being deregulated and made subject to competitive forces. Other services such as transmission and distribution remain regulated because the underlying assets—the "wires"—are natural monopolies. This creates an anomalous situation in which corporate entities jointly own or control regulated and unregulated business functions, creating a powerful incentive to abuse the market power of the regulated functions for the benefit of the unregulated functions. In addition, the transition to competition increases the motivation to consolidate the ownership of generation, increasing the risk associated with the horizontal concentration of generation.

The disaggregation of traditional bundled utility service into separate discrete product and service markets, *i.e.*, unbundling, is essential if a workably competitive marketplace is to evolve. However, the unbundling process opens up a myriad of opportunities by which incumbent, vertically integrated utilities and their affiliates can exercise market power unless adequate new safeguards are in place. In addition, policy makers may unwittingly impose conditions on market participants and market structure that preserve market power and hinder the formation of real competition.

As the electric industry is restructured, it is important that certain structural and behavioral remedies be instituted to check the potential abuse of market power, especially opportunities for new forms of market power to emerge because of the unsettled nature of the transition. **STRUCTURAL REMEDIES** impose limitations on market structure that prevent the existence of market power. Structural remedies are needed because antitrust laws alone cannot eliminate market power. **BEHAVIORAL REMEDIES** allow market power to exist but attempt to "mitigate" the abuse by preventing utilities and any of their affiliates from engaging in anticompetitive behavior by means of regulatory threats, checks, and enforcement. Structural remedies are clearly the more effective solution to the problem of market power. One-time structural remedies also do not require continuing regulatory oversight and remove government from decisions better made by markets. But first there must be markets. Existing federal and state statutes addressing market power never anticipated the changes taking place in the industry and therefore **LEGISLATIVE REMEDIES,** *i.e.*, new laws and regulatory authorities are needed to complement the specific needs for consumer protection in the new industry.

DEFINITION OF MARKET POWER

The classic definition of market power is any behavior on the part of a seller or sellers to profitably maintain prices above competitive levels by restricting output below the levels a competitive market would command.

This definition is the point of departure for any enforcement action by the Federal Trade Commission (FTC) or Antitrust Division of the U.S. Department of Justice (DOJ). In the context of the electric utility industry, a sole seller (*i.e.*, a utility "monopolist") of a service such as transmission, which—by definition—has no effective substitutes for the delivery function, can maintain rates for generation services above the level that would prevail if the market were competitive.[1] The incentive to maintain this "bottleneck" situation increases substantially after the utility's generators have been deregulated and those generators remain dominant in a local market. The utility can increase the delivery cost of potential competing generation services by restricting a competitor's access to transmission services. According to FTC/DOJ *Merger Guidelines*, the result of the exercise of market power is a transfer of wealth from buyers to sellers or a misallocation of resources. The harm to society from the presence of market power is greater than simply the higher costs incurred by consumers. Market power also stifles innovation and productivity.

TYPES OF MARKET POWER

Any formal review of market power, from either an economic or antitrust perspective, begins with a determination of vertical and/or horizontal concentration. For example, under federal law, all corporate mergers and acquisitions are subject to antitrust review for horizontal concentration.

▪ VERTICAL CONCENTRATION

Vertical concentration is a characteristic of the electric industry's integrated structure, *i.e.*, the joint ownership or control of generation, transmission, distribution, customer services such as metering and billing, and sometimes fuel supply and the marketing of appliances and other end-use equipment and services. It is the dominant form of market power in the electric utility industry, and in fact, the electric industry is unique among regulated industries in the degree to which vertical concentration was allowed to exist. Vertical concentration creates a market power concern where the potential for inter-affiliate abuse exists (*e.g.*, cross-subsidization of unregulated business services at the expense of regulated core services) or when the level of concentration is so great that other anticompetitive market outcomes are produced. So-called "convergence" mergers involving both electric and gas businesses are a form of vertical concentration.

▪ HORIZONTAL CONCENTRATION

Horizontal concentration typically involves the acquisition by a firm of that firm's direct competitor(s). Not all horizontal mergers and acquisitions create a potential for the exercise of market power. Horizontal concentration becomes a market power concern when the number of active competitors in the market has been reduced to an anticompetitive level, or one or more competitors become dominant in its market(s). In the electric industry, this form of market power has traditionally been exercised by generation ownership, although horizontal concentration is possible in any regulated or unregulated industry segment. In the transition to a restructured industry, divestiture of generation in states that have adopted retail competition is having the unintended effect of concentrating generation among fewer corporate owners. This is happening before existing transmission bottlenecks are eliminated that would allow the competing services of distant generators into these local markets. Horizontal market power is a form of anticompetitive behavior that is

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[1] Transmission is not subject to antitrust scrutiny because it is regulated. However, the transmission owner's unregulated generation and merchant affiliates should be subject to antitrust review.

independent of vertical integration or the presence of vertical market power. However, there is substantially greater risk to consumers where both forms of market power coexist.

POTENTIAL FOR MARKET POWER ABUSE IN THE ELECTRIC INDUSTRY

The potential for significant market power abuses during and after the transition to a restructured electric industry generally arise because of vertical integration and the joint ownership of regulated and unregulated business functions by the same corporate entity. This is an anomaly among corporate structures in market economies. Since the traditional utility was, by definition, a monopoly with literally unlimited market power (but therefore subject to strict federal and state regulatory oversight), continued vertical integration during (or after) the transition, in which some functions have been deregulated, can preserve the company's market dominance if appropriate remedial measures are not put in place. This "advantage of incumbency" is an inherently unearned competitive advantage and poses a powerful entry barrier to potential competitors. The motive of many mergers (*e.g.*, that involving geographically adjacent electric utilities) may be to maximize this incumbency advantage before real competition has emerged that would check such behavior.

▪ GENERATION MARKET POWER

Generation market power is exercised when the owner of generating units can increase the market price for its product by reducing output or simply by increasing the price offered in the market. Absent market power, the owners of generating units are price takers and cannot directly influence market prices. But with sufficient horizontal market power, an owner of generation can be a price maker in its markets.

Generation market power is most easily exercised through vertical integration with transmission although other ways to exercise this market power also exist.[2] Unfortunately, complete divestiture of generation from transmission is not a perfect remedy for this problem. This results from the fact that generation and transmission, in economic terms, are both *substitutes* as well as *complements*.[3] When a transmission bottleneck occurs, it can be eliminated or reduced by increasing the capacity of transmission lines or by building new generation to offset the need to import power from a distance. Certain geographical configurations increase the potential for generation market power by inhibiting the formation of larger markets. For example, natural peninsulas such as Michigan, Florida, and San Francisco have this problem. At the extreme, these situations—called "load pockets"—require dedicated generating units or so-called "must-run" units to serve the local loads and to provide reactive power support and redispatch services. Such services should be more appropriately considered "transmission" services, and therefore, functionalized as transmission for purposes of continued regulation. These services must not be completely deregulated, but should be brought under the control of appropriately empowered independent regional transmission organizations (RTOs). This is a form of "operational separation" or "operational unbundling" that works more effectively than simple divestiture.

Generation market power is also easy to exercise if barriers to entry keep potential competitors out of the market. For decades, the independent power market faced discrimination because state or local siting laws

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[2]For example, the manipulation of power exchange clearing prices.

[3]If generation was purely the "manufacturing" of energy services, it would perfectly *complement* transmission which transports the energy in the market.

and interconnection rules and practices were systematically biased in favor of utility construction. While some of these preferences are being eliminated, many persist, and some new ones are being created. Many states still require some form of antiquated "determination of need" or "certificate of convenience and necessity" as a precondition to the construction of new merchant power plants. Independent producers are also denied access to the same information available to the utility needed to properly site and connect a new generating unit to the grid. New generation can be made uneconomic if its owners are forced to pay full incremental costs associated with interconnection with the grid while competing generation owned by utilities pay on (or paid) a lesser rolled-in embedded cost basis. Finally, utilities have always enjoyed preferential access to land because as regulated entities they were authorized to exercise the power of eminent domain. Many utilities retain land and permitted sites acquired in this fashion and these resources become an unearned competitive advantage in a restructured industry.

- **TRANSMISSION MARKET POWER**

The potential to use transmission market power is enormously complex because of the manner in which the old industry was structured and regulated. While the Federal Power Act of 1935 gave the Federal Energy Regulatory Commission (FERC) plenary jurisdiction to regulate the rates, terms, and conditions of transmission in interstate commerce, that responsibility was, in practice, shared between federal and state or local regulators, and later, with the North American Electric Reliability Council (NERC). This *de facto* sharing of jurisdiction—some might call a "regulatory gap"—continues and is not only creating new opportunities for the exercise of market power, but is stalling the full implementation of competitive bulk-power markets.

By tradition, state and local regulatory bodies exercise control over transmission services that are bundled with retail services. Under Order 888, these transmission services are exempt from FERC's open-access policies intended to promote competitive wholesale markets. For almost three decades, NERC has operated as a voluntary industry body under the exclusive control of utility monopolies. NERC has unilaterally promulgated so-called "requirements," "standards," and "guides," ostensibly to maintain the reliability of the bulk-power grid.[4] However, these operating practices intend to prescribe the manner in which the grid is operated and directly affect the terms and conditions of transmission services. No NERC requirement or standard has ever been fully adjudicated before FERC or subjected to any other legitimate public process. With these operating practices—and the implied exemption from FERC's open-access policy enjoyed by transmission services used for native load—transmission owners are able to exercise considerable market power and discriminate against potential competitors. Operating procedures that are intended to be used in emergency situations are instead used to curtail the transactions of competitors.

The evolution of competitive wholesale electricity markets has also created a need for standardized commercial practices. These practices include, for example, the procedures for reserving and scheduling transmission services, the procurement of ancillary services, and on-line price negotiation for transmission services. Standardized practices facilitate trading and add to market liquidity by minimizing transaction costs. But absent an independent and impartial forum for developing commercial practices, the industry risks the development of standards that continue to confer preferential treatment to incumbent utilities and their affiliates.

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[4] "Requirements" are the obligations of control areas and other entities who use control area services. "Standards" are requirements that are measurable. NERC Bylaws require mandatory compliance with both requirements and standards. "Guides" are operating practices that control areas and other entities may wish to consider.

▪ LOCAL DISTRIBUTION MARKET POWER

Joint ownership by a utility of regulated local distribution affiliates, and one or more unregulated generation or marketing affiliates, creates a structural incentive to discriminate against non-affiliated generation or marketing companies. The regulated local distribution function gives a utility a powerful incumbency advantage, particularly with respect to the retention of residential and small commercial customer loads. In the transition to competition, the local distribution companies may retain several critical functions (and associated assets) of the previously bundled (vertically integrated) utility: billing, metering, and load shaping services, and customer information. These functions are difficult to spin off or divest, yet they confer considerable market power to the utility if its unregulated marketing affiliates can preferentially access or share these services. This problem is compounded by state restructuring requirements that delegate responsibility for "default service" to the incumbent local distribution affiliate, or where so-called "generation" or "shopping" credits are allowed to be subsidized by the local distribution affiliate.

▪ OTHER SOURCES OF MARKET POWER

The recovery of so-called stranded costs can give utilities new opportunities to exercise market power. The potentially huge cash infusion provided by stranded-cost recovery can endow an incumbent utility with a tremendous competitive advantage, compared with utilities with no such liability, or other potential competitors. As the president of one California utility candidly put it when announcing his company's intention to seek acquisitions: "We are going to have a lot of free cash from stranded-asset recovery ... in the billion dollar range."[5] The cash can be used to cross-subsidize the operations of new unregulated business ventures, or acquire new regulated businesses that increase vertical market power (*e.g.,* natural gas pipelines).

STRANDED COST RECOVERY AND DIVESTITURE

Utilities in a growing number of states are divesting their generation and other assets as part of the restructuring process in those states. In some cases, the decision to divest was mandated by a new state law or by a regulatory order, usually as a precondition to the recovery of stranded costs. In other cases, the decision was the result of negotiations, again usually over the issue of stranded cost recovery. Supporters of divestiture believe that it is the most effective action for determining the market value of the assets and for addressing market power concerns. In addition, any sales premium acquired as a result of the spinoff can be applied to mitigate the total amount of claimed stranded costs.

To date, the results are, at best, mixed, and may be largely symbolic. While divestiture of generation assets has successfully produced market valuations of these assets for the purpose of more accurate (and fair) stranded cost recovery, the claim of market power mitigation is more specious. In many cases, the market power associated with certain generating assets merely changed ownership and was not eliminated. Given that other tools exist for determining an asset's market value (*e.g.,* appraisal) and for addressing market power concerns (*e.g.,* RTOs), mandatory divestiture need not be the sole mechanism for estimating stranded costs.

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[5] "ENOVA, Pacific Enterprises Unveil New Joint Venture," *California Energy Markets,* March 14, 1997, p. 10.

However, there are several valid reasons a utility company might *voluntarily* elect to divest assets. First, the company may decide that the assets do not complement the firm's "core" business. Industry restructuring creates a unique opportunity to redefine a company's business mission that has the greatest promise for maximizing shareholder value. Second, the assets may be under performing, often because the operating costs associated with the assets (*e.g.*, fuel and labor) are not competitive. Finally, some companies may decide that their real expertise is with either the regulated or unregulated aspects of the business, but not both. Workably competitive markets require that a firm's management have the discretion to exercise these choices, and to succeed or fail on their merits. Government should not be a surrogate for the marketplace. This essential feature of competitive markets is sacrificed where divestiture is mandated.

REMEDIES FOR MARKET POWER

Type of Remedy	*Effect of Remediation on Market Power*
▪ STRUCTURAL	▪ Eliminates market power
▪ BEHAVIORAL	▪ Mitigates market power but does not eliminate it. Requires ongoing, often increased, regulatory oversight
▪ LEGISLATIVE	▪ Updates consumer protection laws to complement new industry structure including authorizing new regulatory powers to impose additional structural and behavioral remedies

Mandatory divestiture is a traditional tool of antitrust enforcement that can remedy market power in both the transition from regulation to competition and the post-transition period. Nonetheless, it is a tool that is rarely exercised. When it is exercised, it is usually to mitigate potential horizontal concentration resulting from a corporate merger or acquisition. The U.S. economy is remarkably free from widespread abuses of market power, and the success of our free-market approach is recognized the world over. This is a clear benefit of the sparing use of market intervention, such as mandatory divestiture, by government. Arguably, the mere threat of enforcement is an effective deterrent to anticompetitive practices. This is far superior to any attempt by federal or state government regulators to micro-manage industry behavior and structure. While recent state actions increasingly require some form of asset divestiture, states are urged not to overuse this policy tool.

RECOMMENDATIONS

STRUCTURAL REMEDIES

Certain necessary conditions must be in place before the transition to a competitive electric industry is allowed to start. Failure to do this may only enhance the market power of incumbent utilities and prevent real competition from evolving. The necessary conditions are predominantly structural in nature. This fact is

worth repeating. By eliminating market power, the structural remedies that are proposed will allow real competition to emerge in the industry.

- **OPERATIONAL SEPARATION**

Vertically integrated utilities must be required, at a minimum, to operationally unbundle their generation, transmission, local distribution, and marketing functions into separate corporate affiliated entities. A utility should not be allowed to offer regulated and unregulated products and services through the same corporate entity. A utility may be permitted to establish one or more separate corporate affiliates to offer unregulated products and services only after a finding of no competitive harm. The books and records of each affiliate should be kept separate in accordance with applicable Uniform System of Accounts (USOA) and Generally Accepted Accounting Procedures (GAAP). Corporate entities with both regulated and unregulated affiliates should be subject to strict, ongoing antitrust review and appropriate corrective actions to mitigate the potential for anticompetitive behavior. However, the prospect for antitrust scrutiny does not eliminate the need for operational separation of each affiliate. Finally, the *State Action Doctrine* should not be allowed to grant any implied antitrust immunity.[6]

- **ANTITRUST REVIEW OF NEW MERGERS AND ACQUISITIONS**

State and federal antitrust agencies should assess the market power of new mergers and acquisitions using methodologies based on sound antitrust principles. These agencies should condition any merger approval on structural remedies necessary to eliminate the potential exercise of market power that may result from increased horizontal concentration in generation, such as the divestiture of generation assets, the elimination of transmission bottlenecks, or both.

- **INDEPENDENT REGIONAL GRID MANAGEMENT**

The control of all transmission assets, including must-run generators, must be delegated to large, independent regional transmission organizations (RTOs) with a governance structure totally independent from generation and transmission asset owners. The long-term objective should be interconnection-wide RTOs. The separation of the operation and dispatch of generation from the operation of the transmission system is necessary to assure that transmission market power cannot be used to distort the market for generation services including ancillary services. The terms of the delegation should not allow the transmission owner to retain influence over decisions regarding the day-to-day operation of transmission facilities.

The RTO should operate the grid on a common-carrier basis, subject to the rates, terms, and conditions of a single FERC-approved tariff. All users of the grid should be required to reserve service on the same basis, *i.e.*, using the RTO's *OASIS*. The RTO should implement and enforce North American reliability standards, perform interconnection-wide security coordination, manage transmission congestion on a competitively neutral basis, and prevent market power abuse associated with the provision of ancillary services.

Finally, the RTO should be responsible for the long-term planning of the transmission system. This planning responsibility should also mitigate any action by a transmission owner to exercise market power by delaying the construction of new facilities. The transmission network must also be capable of supporting a competitive

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[6]Under the state action doctrine, state regulation can provide antitrust immunity to certain anticompetitive conduct.

market in generation services. If transmission bottlenecks create entry barriers (and thus preserve generation market power), the bottlenecks must be removed or the market power of the incumbent generation owner(s) must be mitigated, or (preferably) both. This requires an RTO structure that facilitates market-based choices among competing generation and transmission facilities to relieve the constraint. Load pockets and must-run units must also be identified and appropriate regulatory safeguards must be enacted and enforced. Appendix B provides a more detailed summary of ELCON's recommendations on RTOs.

- **UNBUNDLING OF COMPETITIVE PRODUCTS & SERVICES**

All electric products and services that can be offered in competitive markets should be unbundled from regulated service and provided in exclusively competitive markets. The unbundling process must ensure that no costs associated with a competitive service is recovered through the rates charged for a regulated service. In restructuring the electric industry, policy makers should maximize reliance on competition, and less on regulation, as a disciplining factor in the new industry. There should be no presumption of "economies of integration" that requires a regulated entity to provide a bundled product or service that can and should be offered on an unbundled, fully competitive basis. This includes, but is not limited to, billing, metering, and load shaping services; the responsibility for being the "default supplier" or "supplier of last resort;" the right to provide "standard offer," energy efficiency, and "green power" services; and the responsibility for managing retail access service requests.

- **STRUCTURAL REFORMS AS A PRECONDITION TO STRANDED COST RECOVERY**

Stranded cost recovery policies should not be allowed to give utilities with stranded cost liabilities any unearned advantage over utilities which have little or no stranded cost liabilities. Stranded cost recovery mechanisms should bring utility assets to their fair market value. Any below-market valuation of such assets can produce a windfall subsidy for the utility and a greater liability for ratepayers. As a precondition to the recovery of any stranded costs, utilities must take all measures to eliminate or mitigate their market power, including but not limited to, the divestiture of unregulated business functions from regulated services. Other preconditions may include measures such as joining a large independent RTO and relieving transmission bottlenecks. Where necessary, federal and state regulators should also impose restrictions on the use of cash obtained from stranded cost recovery programs where it might otherwise be used to fund an anticompetitive merger or acquisition, or cross-subsidize unregulated ventures.

- **NONDISCRIMINATORY ACCESS TO TRANSMISSION SERVICES**

All requests for transmission reservation and scheduling services should be offered on a fair and nondiscriminatory basis, and publicly reported and made equally accessible to all market participants on a timely basis. All users of the transmission system should be subject to the same rules of access and rates, terms, and conditions of service. Even the perception of discrimination can inhibit competition by discouraging market entry by potential market participants most vulnerable to discrimination.

For competitive transactions, insider trading and market manipulation limitations and penalties, equivalent to those imposed by the Securities & Exchange Commission, should be established and enforced.

EXAMPLES OF MARKET POWER I	
INDUSTRY SEGMENT	**FUNCTIONS AT RISK**
GENERATION	▪ Ancillary services ▪ Maintenance scheduling ▪ Must-run units ▪ Bidding into power exchanges ▪ Emission allowances ▪ Joint ownership ▪ Generation sales at retail
TRANSMISSION & SYSTEM OPERATIONS	▪ Congestion management ▪ OASIS (service reservations) ▪ Rates, terms, and conditions of access ▪ Ancillary services ▪ Interconnection rights ▪ Capacity benefit margin (CBM)
NERC OPERATING POLICIES & COMMERCIAL PRACTICES	▪ Inadvertent interchange (Policy 1 and Policy 9) ▪ Generation (Policy 1) ▪ Interchange transactions tagging (Policy 3) ▪ Emergency operation (Policy 5) ▪ Transmission loading relief (Policy 9) ▪ Security coordinator procedures (Policy 9) ▪ Interconnected operations services (IOS)
LOCAL DISTRIBUTION	▪ Rates, terms, and conditions of access ▪ Billing & metering services ▪ Default service/standard offer services ▪ Customer information ▪ Energy balancing or load shaping services ▪ Retail access service requests
WHOLESALE MARKETING	▪ Transactions with regulated affiliates
RETAIL MARKETING	▪ Transactions with regulated affiliates
CONVERGENCE SERVICES (E.G., NATURAL GAS)	▪ Joint marketing of competing products and services ▪ Natural gas pipelines ▪ Rights of way and easements
NON-CORE BUSINESSES & SERVICES	▪ Marketing of services such as security systems, appliance sales and repair, and real estate

THE TRANSITION TO COMPETITION

FORMS OF ABUSE	REMEDIATION
▪ Horizontal market power (reducing output below competitive level or raising its offer prices above the competitive level in order to increase market price) ▪ Reduce transmission capacity by not supplying reactive power ▪ Impute generation or shopping credits based on wholesale energy costs only	▪ Independent RTOs ▪ Fair and nondiscriminatory rates, terms, and conditions for ancillary services ▪ Generation or shopping "credits" include costs of additional services that have to be bundled with wholesale energy to make it usable (e.g., load shaping services, losses, and profits)
▪ Increase rates by restricting access or delaying the construction of new or enhanced facilities ▪ Deny access to non-affiliated users ▪ Preferential treatment of wholesale marketing and generation affiliates ▪ Restrict interconnection by new generators Hoard ATC	▪ Full comparability of access (all uses of the transmission system must use *OASIS*) ▪ Elimination of rate pancaking ▪ Operational separation ▪ Independent RTOs ▪ Pricing transparency in wholesale spot markets
Preferential treatment of transmission owners' affiliates Preferential treatment of local generation and loads Entry barriers to new market participants and innovations Playing the "reliability" card to limit development of competition	▪ Federal accreditation of separate North American reliability and commercial practices organizations with limited antitrust exemption ▪ Independent governance ▪ Independent security coordinators ▪ Independent RTOs (with interconnection-wide security coordinator responsibilities)
Horizontal market power and ability to retain retail load via incumbency advantage Entry barriers to new market participants and innovations Preferential treatment of retail marketing and generation affiliates Inordinate penalties for energy imbalances	▪ Unbundle all competitive products and services ▪ Availability of dynamic balancing or an active, competitive energy balancing market ▪ Enforce "Codes of Conduct"
Cross-subsidization by regulated affiliates	▪ Enforce "Codes of Conduct"
Cross-subsidization by regulated affiliates	▪ Enforce "Codes of Conduct"
Reduced level of competition (electricity and natural gas compete for same end users) Predatory pricing to build market share by cross-subsidization Preferential treatment of customers that purchase other services Increase competitors' fuel costs	▪ Federal legislation granting FERC and states unambiguous authority to address and remediate any market power concern ▪ Federal legislation clarifying FTC & DOJ authorities to approve mergers that foster competition
Cross-subsidization by regulated affiliates	▪ Enforce "Codes of Conduct" ▪ Restrictions on proceeds of stranded cost recovery

■ NO ARTIFICIAL IMPEDIMENTS TO COMPETITION

The benefits of restructuring should result from competition and not imposed by other means. For example, ill-defined "standard offers" and generation or shopping "credits" can act as powerful barriers to competition by conferring an unearned and unnecessary advantage to the incumbent utility suppliers. In addition, residual restrictions on the construction of new generators, including siting and interconnection practices that systematically give preference to utility construction, or confer market power on incumbent owners of generation. Such restrictions and practices should be eliminated. Eminent domain authority for the siting of generation assets must be available to all potential sellers of generation, or to none. The incumbent owners of generation, transmission or distribution must not be the sole beneficiaries of eminent domain powers.[7]

BEHAVIORAL REMEDIES

All market power cannot be eliminated. This is particularly true if joint ownership of regulated and unregulated utility affiliates is allowed. Strong behavioral remedies are necessary to mitigate this market power. Behavioral remedies will be successful—in the longer term—if the market discourages the continued joint ownership of regulated and unregulated business functions. The market may judge that the coexistence of such business functions is inherently inefficient and not in the best interests of the company's shareholders.

■ ANTITRUST ENFORCEMENT

Antitrust enforcement should increase commensurate with the pace of deregulation. Thus, as regulatory safeguards are relaxed in the electric industry, the new deregulated business functions become subject to the same antitrust scrutiny faced by other competitive industries. However, antitrust is only an after-the-fact measure, and therefore, is not a substitute for establishing a competitive market structure at the outset.

■ PROHIBITION ON STRANDED COST RECOVERY AS A BARRIER TO COMPETITION

Utilities that are allowed the recovery of stranded costs should not be allowed to use the proceeds of such recovery for any new investments in unregulated businesses. The proceeds of stranded cost recovery should be used to retire debt associated with the stranded assets, redeem bonds, or buy back stock

■ REGULATION OF DISCRIMINATORY AND OTHER ANTICOMPETITIVE BEHAVIOR

All utilities and their affiliates must be subject to strict "codes of conduct" for governing the transactions between such affiliates and with non-affiliated entities.[8] Such "codes of conduct" should include prohibitions on cross-subsidization and self-dealing; restrictions on the transfer of assets or services between affiliates; restrictions on directors, officers, and other employees; prohibitions on any form of preferential treatment

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[7] In some states, this may require a legislative remedy.

[8] An "affiliate," by one definition, is a company which a utility, its subsidiary, its parent or a subsidiary of the utility's parent has the power to control. The ability to control another company is presumed where a utility (subsidiary, parent, etc.) owns 5% or more of the outstanding voting shares. The term "affiliate" also includes the utility's parent or holding company, or any other company which owns 10% or more of the outstanding voting shares of the utility.

between affiliates, including joint ventures or partnerships; and compliance and enforcement procedures. A model "codes of conduct" is recommended in Appendix A. This model is applicable to the unregulated affiliates involving both retail and wholesale transactions.

LEGISLATIVE REMEDIES

The restructuring of the electric industry will—by definition—reduce the reach of federal and state regulation over deregulated segments of the old industry. However, existing federal and state consumer protection laws never anticipated this restructuring, particularly the introduction of retail access. These laws need to be reformed to complement the new industry structure. Federal and state regulators will need some limited new authorities to impose additional structural and behavioral remedies necessary to eliminate or mitigate market power. These include:

▪ ADEQUATE REGULATORY AUTHORITIES

Federal legislation should give state and federal regulators and antitrust agencies unambiguous authority to address and remediate any market power concern associated with the provision of any regulated service, including any transaction between regulated and unregulated affiliates of the same utility.

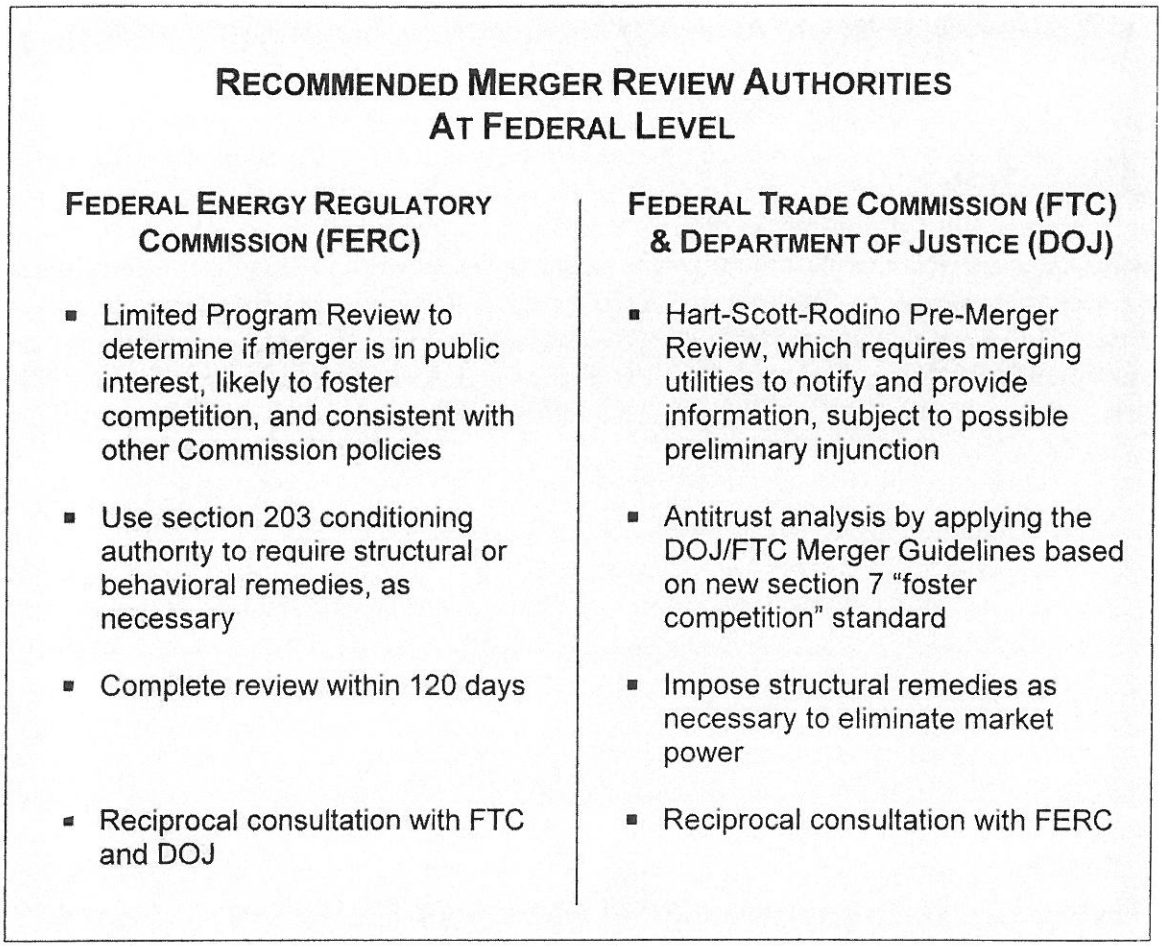
Specifically, Congress should clarify and expand the authority of the states and FERC to require and police the operational separation of regulated and unregulated affiliates, and to impose restrictions on inter-affiliate transactions to ensure that customers of regulated services do not subsidize the activities of unregulated affiliates. Consumer protection must be made the primary objective in approving and reviewing inter-affiliate transactions. Congress should clarify and expand the authority of FERC to use accounting conventions and "codes of conduct" for mitigating market power. Congress should not mandate divestiture but should authorize FERC to do so, as necessary to eliminate market power, and clarify that states are not preempted from doing so.

▪ ACCESS TO BOOKS AND RECORDS

The personnel, accounts, books, records, and other materials of any utility affiliate should be made available for examination and auditing by any state commission, FERC, FTC, DOJ, and their respective staffs. A utility must seek state regulatory commission approval for all transactions between the utility and/or any of its regulated affiliates, or any of its unregulated affiliates, that potentially affect the service provided to retail customers.

▪ MERGER APPROVALS

Congress should limit the authority of FERC's section 203 review of merger proposals to program review to ensure that a proposed merger is consistent with FERC policies and rules. FERC should consider whether the merger is in the public interest in that it is likely to foster a competitive market consistent with the objectives of industry restructuring. As necessary, FERC should use its section 203 conditioning authority to impose conditions—such as ordering structural reforms—on merger applicants to assure that the merger serves the public interest. Congress should clarify FERC's responsibility to evaluate a proposed merger's impact on both wholesale and retail markets. FERC program review should be concluded within 120 days.



Congress should also transfer the authority to apply antitrust merger analysis from FERC to the Federal Trade Commission (FTC) and the Department of Justice (DOJ). Congress should clarify that FTC and DOJ have sufficient statutory authority to review such mergers and to only approve mergers that foster competition and are otherwise in the public interest and consistent with the objectives of deregulation. Funding for the Antitrust Division of the DOJ and the FTC comes out of a special fund consisting of filing fees paid by the merger applicants. Any civil or criminal penalties attained by the agencies go into the U.S. Treasury's general funds. In essence, antitrust enforcement can pay for itself. Congress is urged to appropriate and authorize adequate funding of the antitrust agencies to meet these new objectives, including as necessary, applying civil and criminal fines to the antitrust budget.

- **INDEPENDENT RELIABILITY & COMMERCIAL PRACTICES STANDARDS-SETTING ORGANIZATIONS**

Federal legislation should authorize separate North American organizations for establishing: (1) reliability standards for the competitively-neutral operation of the interconnected grid, and (2) commercial practices that enhance the regional scope and liquidity of bulk-power markets. Each organization should be subject to FERC oversight and have independent governance structures. Canadian and Mexican regulatory authorities are urged to provide comparable oversight over their respective jurisdictional entities. Congress should clarify the authority of FERC to order the establishment of large, independent regional transmission organizations (RTOs), and to reconcile any differences between the reliability and commercial practices organizations.

▪ CONDITIONAL REPEAL OF PUHCA & PURPA

The Public Utility Holding Company Act of 1935 (PUHCA) and the Public Utility Regulatory Policies Act of 1978 (PURPA) provided important consumer protections in the traditional regulated industry. Those protections should not be relaxed prematurely. Any legislation to repeal or reform PUHCA should ensure that states have adequate authorities to fill regulatory gaps in state laws and regulations that may result from the repeal or reform of PUHCA. The mandatory interconnection, backup power, and purchase obligations imposed by PURPA Title II on electric utilities were necessary to reduce utilities' monopsony power, *i.e.*, the utilities' position as the exclusive buyers of electricity for their service territories and the only points of access to the transmission grid. PURPA should remain in effect until these monopsony powers have been eliminated. Therefore, the repeal of PUHCA and section 210 of PURPA in federal legislation should be conditioned on the successful implementation of retail access in all 50 states and the District of Columbia.

CONCLUSION

The transition to a more competitive electric industry creates new opportunities for market power because of the joint ownership of regulated and unregulated business functions. In addition, existing transmission bottlenecks increase the risk of horizontal concentration in the ownership of generation as the generation markets undergo rapid consolidation. A truly competitive industry will not emerge absent effective elimination and mitigation of the various forms of market power. Structural remedies are the most effective way to deal with market power. But behavioral remedies will also be needed until the market itself discourages such joint ownership. New consumer protections laws are also needed to complement the new industry structure. These remedies are essential preconditions for the creation of real competition in the electric industry where competition can exist. Markets cannot make these changes if the requisite markets do not first exist. Policy makers—both regulatory and legislative—bear the responsibility for ensuring that these preconditions are put in place.

Appendix A

MODEL "CODES OF CONDUCT" FOR INTER-AFFILIATE TRANSACTION

PROHIBITION ON CROSS SUBSIDIZATION AND SELF-DEALING

Cross subsidies and any form of cost shifting between a utility or any of its regulated affiliates and any unregulated affiliates are prohibited. The products and services of any unregulated affiliates shall not be directly or indirectly subsidized with any revenues earned by the sale of services subject to regulated rates, terms, and conditions.

TRANSFER OF ASSETS OR SERVICES AT MARKET VALUE

A utility or any of its regulated affiliates is prohibited from selling, leasing, or otherwise transferring tangible or intangible assets or services to any unregulated affiliate, the costs of which have been included in regulated rates, at less than market value.

WORK PLACE RESTRICTIONS

The directors, officers, and employees of a utility and any of its regulated affiliates and those of its unregulated affiliates shall operate independent of each other. Any employee of a utility's unregulated affiliates shall not be involved in the utility's management decisions concerning the day-to-day operation of its regulated transmission and/or distribution systems, including but not limited to, decisions relating to available transfer capability, reservation and scheduling, redispatch, load curtailments, and any declaration of system emergencies or similar contingencies that may impair reliability. Any employee of a utility's unregulated affiliates shall not have access to any information, personnel of the utility or any regulated affiliate, or facilities (including system control centers) that differs in any way from the access available to any nonaffiliated entity or competitor.

TRANSFERS OF EMPLOYEES

Employees of the utility and any of its affiliates shall not be precluded from transferring between corporate entities as long as such transfer is not used as a means to circumvent the "codes of conduct." Notices of any employee transfer to or from any regulated affiliate shall be posted on the *OASIS* and other publicly accessible places as deemed appropriate by FERC, and any state or local regulatory body. The utility or its regulated affiliate shall be reimbursed by an unregulated affiliate for the full costs of any training or similar benefits received by an employee while employed by the utility or its regulated affiliate upon returning to an unregulated affiliate from the utility or any of its regulated affiliates. Once transferred, the employee shall not be allowed to return to its former employer, or another affiliate, for two years.

COMPETITIVELY-NEUTRAL RATES, TERMS, AND CONDITIONS

A utility shall apply all rates and tariff provisions on a nondiscriminatory basis to all affiliated and nonaffiliated entities and customers including all customers served under the same or comparable tariff services or non-tariff offerings. A utility shall not, through a tariff or other provision, give its unregulated affiliate or customers of such affiliates any preferences over nonaffiliated suppliers or customers with respect to any transmission, distribution, interconnection, or any other service offered by such utility. Any rebates, discounts, or fee waiver of any regulated utility service offered by a utility directly or indirectly to its unregulated affiliate or to a customer of its unregulated affiliate, shall be simultaneously offered on an open and nondiscriminatory basis to all competing marketers, suppliers, or customers. All such offerings shall be openly disclosed on the Internet and made available upon request.

LIMITS ON USE OF RETAIL CUSTOMER INFORMATION

Customer data (including any form of request for service) and other marketing information acquired through the provision of any regulated service at retail shall be made available to all competing suppliers under the same terms and conditions. The use or release of any customer-specific information, including usage and billing records, is prohibited without prior written notification and approval of the customer. Utilities and their regulated affiliates shall have the burden of proof to demonstrate that customer information in their possession has not been improperly withheld from other competing suppliers.

PROHIBITION ON ASSIGNMENT OF RETAIL CUSTOMERS

A utility or any of its regulated affiliates shall not assign customers to which it currently provides services to any of its affiliates, whether by default, direct assignment, or by any other means, unless that means is equally available to all non-affiliated competitors. In all cases, customers shall be notified of and requested to approve any such new assignment.

PROHIBITION ON TYING OF SERVICES

A utility or any of its regulated affiliates shall not condition or otherwise tie the provision of any services provided by the utility, nor the availability of discounts of rates or other charges or fees, rebates, or waivers of terms and conditions of any services provided by the utility or regulated affiliate, to the taking of any products or services from its unregulated affiliates.

PROHIBITION OF JOINT VENTURES

A utility or any of its regulated or unregulated affiliates shall not engage in any form of joint marketing or advertising, partnership involving the joint ownership or control of assets or the sharing of expenses, or other collaborative effort for their mutual benefit.

PROHIBITION ON MISREPRESENTATION OF AFFILIATE RELATIONSHIP

A utility or any of its regulated affiliates shall not act or speak on behalf of its unregulated affiliates or give the appearance that it is acting or speaking on behalf of any such affiliate. Unregulated affiliates of any utility shall not claim, promote, or suggest to any customer or supplier that it may receive preferential treatment with respect to any regulated or other service as a result of its affiliation with the utility or any of the utility's regulated affiliates.

MAINTENANCE OF WRITTEN PROCEDURES

A utility shall file with FERC and all applicable state and local regulatory bodies written procedures implementing these codes in such detail as shall enable customers, suppliers, or any regulatory body to determine that the utility and any of its affiliates are in compliance with the codes. The utility shall maintain such written procedures in a public place, including on the Internet.

COMPLIANCE AND ENFORCEMENT

The books and records of the utility and any of its affiliates shall be available for review and auditing, at the utility's expense, by any of the utility's jurisdictional regulatory bodies, including FERC. Procedures for implementing compliance with these "codes of conduct" shall be neutral and swift, and the penalties for non-compliance shall adequately discourage repeat violations. These rules shall be interpreted broadly to effectuate the objectives of fostering fair competition, enhancing reliability, and protecting consumer interests.

EMERGENCY CONDITIONS

The utility shall report to the FERC, all applicable state or local regulatory bodies, and on the *OASIS* each emergency that resulted in any deviation from the "codes of conduct," within 24 hours of such deviation.

Appendix B

SUMMARY OF ELCON'S RECOMMENDATIONS FOR REGIONAL TRANSMISSION ORGANIZATIONS

The ownership and operation of the huge North American electric grid is incompatible with two overarching objectives of electric industry restructuring: (1) the establishment of the largest possible commercial markets for electricity and (2) the development of nondiscriminatory and competitively-neutral reliability standards. The grid is, in reality, three separate grids (or "interconnections"), and there are over a hundred owners each trying to operate its small portion of the grid as if it were a separate, isolated network. By acting in their own self-interest, owners jeopardize both the reliability needs of the interconnection and competition in interconnection-wide bulk-power markets.

▪ RTO GEOGRAPHY & CONTROL AREAS

The Federal Energy Regulatory Commission (FERC) should establish as a matter of policy a rebuttable presumption that the three interconnections are the optimal size and scope for RTOs. These RTOs should replace both the 10 regional councils and the ISOs that have been established. Each RTO should enforce FERC-approved reliability standards, including acting as security coordinator for the interconnection. The formation of RTOs is a structural requirement of competitive bulk-power markets. If properly implemented, RTOs replace the need for more expansive regulatory oversight in the future.

Each RTO should have single control area responsibilities for the purposes of providing transmission services and maintaining reliability, but not for economic dispatch. Replacing the essential functions of multiple system operators, regional councils, security coordinators, and existing "ISOs" with a single RTO promotes efficiency by eliminating redundant layers of bureaucracy, needlessly complex operating practices, and the potential for human error. Those who would argue for more than three RTOs have the burden of proof to demonstrate that more RTOs will enhance reliability and competition.

▪ RTO GOVERNANCE & ROLE OF TRANSCOS

Each RTO, at least initially, should be a nonprofit organization because its enforcement responsibility would conflict with a for-profit motive. This policing function is necessary to mitigate the market power resulting from vertical integration. Each RTO should have an independent board. These conditions can be relaxed, and the RTO may be replaced with an investor-owned transmission company (or transco), if and only if it can be demonstrated that: (1) a working secondary market for transmission capacity rights and other conditions, as necessary, adequately eliminates transmission market power and (2) the ownership of each interconnection's transmission assets is sufficiently consolidated into a single transco unaffiliated with any generation, power marketing, energy services, or local distribution company or utility. Even if these conditions are met, the need remains for continued regulatory oversight and an independent dispute-resolution process. Whether such huge transcos can replace RTOs, the desired corporate structure of a *transmission owner* is an independent, unaffiliated profit-making entity. The grid's value in a large regional market is greater than the sum of its parts. This alone should create the economic incentive to create transcos and join an RTO. Finally, an interconnection-wide RTO provides the benefits of a large, reliable market without the requirement or risk of private ownership of such a huge essential facility.

- **RTO RESPONSIBILITIES**

Each RTO should have adequate control over transmission facilities so as to fulfill its essential responsibilities. These include calculating the amount of transmission capacity available in the market, posting that amount on the FERC-mandated transmission reservation system (OASIS), administering a single grid-wide transmission tariff and the OASIS, processing requests for and scheduling transmission services through participating control areas, providing congestion management services, and monitoring and ensuring that ancillary services are being adequately provided and scheduled. The degree of operational control RTOs have over transmission facilities should be commensurate with the amount of market power retained by transmission owners. This should be determined on a case-by-case basis.

- **WHAT RTOS MUST NOT DO**

For any unregulated electricity product or service, the RTO should not make the market, guarantee market outcomes according to preconceived technical or economic rules or myths, or interfere in any way such as to prevent market clearing prices from reflecting the combined economic behaviors of buyers, sellers, and independent market intermediaries. The RTO should not operate a spot market (or power exchange) in any electricity commodity or service.

- **TRANSMISSION PRICING & CONGESTION MANAGEMENT**

RTO formation should not be held hostage to the need for transmission pricing reform. It is far easier to evolve to a more efficient pricing regime after a few large RTOs are created. An RTO should administer a single grid-wide, open-access transmission tariff on a nondiscriminatory basis. The tariff of an interconnection-wide RTO should internalize loop flows and eliminate the "pancaking" of rates.

The redispatch costs associated with most occurrences of congestion, wherever located, should be averaged across all users in the postage-stamp rate. Alternatively, but only after interconnection-wide RTOs have been created, pricing "zones" may be established within the RTO grid where congestion conditions are relatively severe and failure to address such costs results in one group of market participants being unduly discriminated against for the benefit of another. Capacity rights across congested interfaces should be established and subject to an auction that ensures an efficient and fair allocation of capacity reservations. A secondary market for these reservation rights should be allowed to develop independent of the RTO. This market would establish valuations of specific congested interfaces and provide an important "price signal" for new investment decisions.

- **INCENTIVES TO BUILD NEW FACILITIES**

The claim that transmission owners do not receive adequate economic incentives to build needed new transmission capacity is overstated. The divestiture of generation, the creation of stand-alone "wires" companies, the entry of third-party owners of assets, and other ongoing restructuring activities are creating new opportunities in the industry. These opportunities to serve a larger, more dynamic market are adequate incentive for any rational business, perhaps even a monopoly. This new industry structure needs to be tested before regulators rush to propose additional incentives. The need may not be there.