DEPARTMENT OF JUSTICE

STATEMENT

of

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Electricity Competition:
Market Power, Mergers and PUHCA

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Good morning, Mr. Chairman and Members of the Subcommittee. I appreciate the opportunity to speak to you about some of the issues relating to market power in the electric power industry.

With sales totaling more than $200 billion annually in the U.S., it would be hard to overstate the importance of the electric power industry to the American economy and to American families. All of us have a stake in eliminating obstacles to efficient and economical generation and transmission of electricity.

The electric power industry developed historically from a patchwork of isolated and vertically integrated electric utilities, each generating and distributing electric energy to consumers in relatively compact service areas. Advances in technology over time made power generation more efficient on a larger scale and made transmission of electric energy possible over long distances. These advances encouraged interconnection among utility transmission networks, initially for enhanced reliability and then for improved economy of service.

More recently, it has become possible, with improved technology, to generate electric power at efficient cost levels with much smaller generating plants. There is now a growing consensus that the generation segment of electric power supply could become more efficient and economical under competitive market forces. The transmission and distribution segments, on the other hand, will likely retain their natural monopoly characteristics for the foreseeable future. The challenge, then, is to foster vigorously competitive generation markets within the context of regulated transmission and distribution monopolies. It is in pursuit of the goal of promoting competitive generation markets that the Administration submitted its comprehensive electricity restructuring bill to Congress last month.

In thinking about restructuring, it is important to remember that the electric power industry has a number of unique characteristics that distinguish it not only from basic manufactured goods markets, but also from other network industries such as telecommunications. The product -- electric energy -- cannot be stored; and consumer demand for it varies widely from season to season, from day to day, and from hour to hour. Actual quantities generated must continuously and instantaneously match widely varying consumer demand.

In addition, the flow of energy over an electric power network cannot economically be directed through switches to follow a particular path, so in the power grid of today and the immediate future, energy will flow along the path of least resistance. Therefore, the actual physical delivery patterns for electricity may not match the contractual arrangements for sale of electricity, and successful transmission will depend on the relative output levels of all generators on the power grid.

Many states are moving to open their retail markets to competition. It is thus important that Congress consider the need for federal legislation to address possible market power problems that could impede the efforts to increase competition in the electric power industry. We believe that the bill that the Administration submitted to Congress comprehensively and adequately addresses the market power issues about which we are all concerned.

The keys to retail competition in the electric power industry are well-functioning wholesale markets. Although much progress has been made in this regard, there is more to be done. Because power markets are regional in nature, federal legislation to remove impediments to competition in these markets is necessary.

In what follows, I will outline the views of the Department of Justice about the basic components of such legislation. I will first give a brief overview of enforcement activity by the Department in the electricity industry. I will then discuss some of the market power problems facing the industry and legislative proposals that we believe are necessary to address them. And I will conclude by discussing possible reform of the Public Utility Holding Company Act of 1935.

Enforcement Activity of the Antitrust Division

The Antitrust Division has long played an important role in protecting and promoting free and open markets in the electric power industry. A seminal antitrust case in this industry was an enforcement action brought by the Antitrust Division under the Sherman Act to stop the Otter Tail Power Company from monopolizing the retail distribution of electric power in its service area in Minnesota, North Dakota, and South Dakota. Otter Tail owned the transmission lines in its service area, and one of the means it employed to monopolize the market was to refuse to transmit, or "wheel," power over its lines to municipal utilities competing with it for local distribution. In 1973, the Supreme Court upheld a lower court order requiring Otter Tail to wheel power to the municipal utilities, ruling that the electric power industry was subject to the antitrust laws even though it was also subject to regulation by the Federal Power Commission.

The Division has brought two recent enforcement actions involving the electricity industry. The first was an action against Rochester Gas and Electric (“RG&E”) concerning a contract between RG&E and the University of Rochester in which RG&E promised to sell electricity to the University at

reduced rates in exchange for the University's promise not to compete against RG&E in the sale of electricity to consumers.

The case had its origin in the very high regulated electricity rates in New York in the early 1990s. In response, the New York Public Service Commission opened a proceeding to permit utilities to set prices through individual negotiations with certain customers rather than according to a tariff filed with the state.

In the meantime, the University of Rochester, a major industrial customer of RG&E, was examining ways to reduce its energy costs. The University had a decades-old facility that produced steam for heating and cooling campus buildings. The University determined that it could build a more efficient plant to meet its steam needs and also produce -- or cogenerate -- more electricity than it needed as a byproduct. New York State law expressly permitted the University to sell the plant's excess electricity to other users, in competition with RG&E.

The new plant was never built. Instead, RG&E and the University entered into an agreement. In part, the agreement resembled a simple -- and legal -- requirements contract, under which RG&E agreed to supply the University with electricity at discounted rates and the University agreed to "remain a customer of RG&E for all of its power needs" for seven years. But the agreement did not stop there. It also contained a seven-year restriction, unrelated to RG&E's sale and the University's purchase of electricity, pursuant to which the University promised "not to solicit or join with any other customers of RG&E to . . . provide them with electric power . . . from any source other than RG&E."

The Division brought an action under the Sherman Act against RG&E, challenging the agreement not to compete between RG&E and the

University. This action was resolved by a consent decree that prohibits RG&E from entering into agreements not to compete, with certain limited exceptions (for example, contracts to sell a business).

The second action was a challenge of the merger of Pacific Enterprises ("Pacific"), a California natural gas utility, and Enova Corporation ("Enova"), a California electric utility. The Department was concerned that, as a result of the merger, the combined Pacific/Enova would have the incentive and ability to use its natural gas transportation monopoly to withhold gas or gas transportation from competing gas-fired electric plants that competed with Enova. Gas-fired plants are generally the most costly to operate, and they set the price for all electricity sold during times, such as summer, when electricity demand is at its highest. The complaint alleged that Pacific/Enova would, by restricting the access to natural gas of certain competing gas-fired plants, be able to raise their costs and thereby to increase electricity prices to California consumers. The complaint further alleged that Pacific/Enova would have an incentive to do so because it is a low-cost producer of electricity and would therefore stand to profit from any increase in the price of electricity.

The settlement requires Enova to divest its largest low-cost electricity plants. Once this is accomplished, the merger will no longer create incentives for Enova to raise electricity prices. Enova is also required to provide notice to and obtain the approval of the Department should it wish to acquire or manage certain California electric power facilities in the future.

Market Power

Let me now turn to the issue of market power. Because of the existing structure of the electric power industry, there are likely to remain significant

market power problems in the transmission and generation of electricity, even as the industry is restructured to increase the role of competitive market forces.

The authority of the Department of Justice to enforce the antitrust laws with respect to the electric power industry does not sufficiently address the ability of electric utilities to exercise market power that can thwart free competition within the industry. The antitrust laws do not outlaw the mere possession of monopoly power that is the result of skill, accident, or a previous regulatory regime. Antitrust remedies are thus not well-suited to address problems of market power in the electric power industry that result from existing high levels of concentration in generation or vertical integration. In the Administration's electricity bill we have, therefore, granted regulators the tools to remedy market power problems that may be found to exist.

The provisions that would give FERC clear authority to remedy possible market power problems are an important part of the Administration's recently unveiled Comprehensive Electricity Competition Act. Let me explain why.

Transmission Access

Owners of electric power transmission facilities in the U.S. commonly also own generation facilities, and their control over transmission gives them the ability to thwart competition in generation. Owners of transmission have the incentive and the ability to favor their own generation facilities and otherwise to restrict the access to transmission facilities by the generation facilities of competitors. Such discrimination can take the form of denying competitors in electricity generation access to the transmission monopolist's

services or offering less favorable terms than those provided to its own generation facilities. The FERC took an historic step toward addressing this problem by enacting Order 888, which requires that all utilities over which FERC has jurisdiction provide open and nondiscriminatory access to transmission facilities for wholesale buyers and sellers.

Monitoring and enforcing compliance with regulations against discrimination are particularly difficult, however, when quality of service is as time-sensitive as it is in electric power. Because power is sold on an hourly basis, market dynamics -- and thus the incentive and ability to exploit market power -- can shift over the course of each day, making it virtually impossible to intervene before conditions have changed. There is thus no way to ensure that a transmission owner will not operate its transmission assets in a manner that favors its own generation.

Independent Regional System Operators ("RSOs") are a promising solution to this problem. RSOs are entities that operate the transmission grid independent of the interests of the owners of the generation facilities. The Administration proposal calls for amending the Federal Power Act to clarify that FERC has the authority to require transmission utilities to turn over operational control of transmission facilities to a regional independent system operator. FERC would also be given the authority to set other requirements pertaining to RSOs as needed to serve the public interest. Such a structural remedy can eliminate the incentive and ability of the owner of monopoly transmission facilities to act anticompetitively by ensuring that transmission services are provided to competitors by a neutral entity which has no stake in any particular generation facility and thus has no incentive to discriminate.

It is critical that RSOs be large enough to operate the transmission system efficiently and reliably. The provision in the Administration proposal authorizing FERC to establish minimum criteria for the approval of RSOs would allow FERC to reject RSOs that may be improvements over the status quo but are too small to operate the transmission system reliably and efficiently.

Optimally-sized RSOs can also help to mitigate market power that is the result of high concentrations of ownership of generation assets. RSOs can do so by eliminating transmission rate pancaking and thereby enlarging geographic markets. Rate pancaking occurs when a transmission customer is forced to pay separate rates for a transaction that crosses multiple transmission systems, even though the total costs of the systems would produce a rate, if the systems were treated as one, that is lower than the sum of the "pancaked" rates. Pancaking results in total transmission prices that do not accurately reflect the actual cost associated with a particular transaction. It thus distorts competition both by increasing transmission prices and by tending to insulate nearby generation facilities from what might otherwise be more vigorous competition from more distant facilities.

Large regional RSOs can also internalize certain transaction costs, such as those associated with loop flows, as well as play an important role in the control and management of constrained transmission interfaces, particularly those which significantly impact competition in regional power markets. Poorly managed, competitively significant constraints can hinder transactions across the interface and invite anticompetitive manipulations of the interface. We fear that, without independent operation of the transmission grid, regulators will be unable to address adequately the almost certain flood of complaints of self-dealing that will undoubtedly allege

manipulations of posted available transmission capacity and abuses of the native load preference that is granted utilities under Order 888.

Some transmission owners may decline voluntarily to turn over control of their transmission facilities to an ISO. Given the importance of ensuring that the transmission system operates in a nondiscriminatory and efficient manner, it is critical to competition in the electricity industry that legislation clarify FERC's authority to order transmission owners to join FERC-approved RSOs.

Generation Market Power

High concentrations of ownership of generation may allow the exercise of market power, even if there is competition in wholesale and retail markets. The Administration bill would give FERC the authority to mitigate market power in wholesale markets, as well as backup authority to remedy market power in retail markets upon request from a state if the state, in the course of implementing a retail competition plan, determines that it has insufficient authority to remedy a retail market power problem. Consistent with the Department's strong preference for structural remedies for competitive problems, FERC would be given express authority to order divestiture of generation facilities to the extent necessary to mitigate market power, in consultation with the Department and the Federal Trade Commission. The authority would be implemented by requiring generators with market power to submit a mitigation plan, which FERC could approve with or without modification.

Giving FERC the necessary tools to remedy market power in generation is critical because vertically integrated electric utilities have typically had market power in their distribution areas, and significant pockets

of market power may remain after wholesale and retail competition are widely introduced. We do not know the extent to which this will be the case after restructuring occurs, but if it turns out that there are significant post-restructuring market power problems, FERC must be given the necessary tools to address them.

PUHCA Reform

I would like to conclude my testimony by briefly discussing possible reform of the Public Utility Holding Company Act of 1935 ("PUHCA"). During the Great Depression, a handful of large multi-state corporations that controlled a significant amount of electricity generation and transmission collapsed. Congress responded by enacting PUHCA. This legislation split up the companies and imposed certain restrictions on utilities operating in more than one state. The result has been an industry dominated by vertically integrated utilities regulated by state commissions.

The Administration opposes standalone repeal of PUHCA. In our view, the interlocking nature of the system of federal laws regarding utility regulation, including PUHCA and the Federal Power Act, makes it preferable that these statutes be amended either as part of comprehensive restructuring legislation or concurrently with such legislation, rather than on a piecemeal basis.

The Administration's restructuring legislation includes a repeal of PUHCA. However, the bill also includes several measures designed to protect consumers from the potential for holding company abuses such as cross-subsidization. These measures should include enhanced merger review by FERC, additional state and federal access to holding company data, and the market power provisions I discussed earlier. The

Administration believes that it is important to approach electricity restructuring issues comprehensively in order for Congress to be able to evaluate the context in which changes in PUHCA are to take place.

Conclusion

We are confident that truly competitive electricity generation will surpass regulation in efficiently allocating resources and maximizing consumer welfare. Moreover, we believe that the Administration's electricity bill comprehensively addresses the competitive issues that will arise in a restructured market, and establishes the framework through which truly competitive markets can thrive. We look forward to continuing to work with the Subcommittee on the important issue of market power.