

UNITED STATES OF AMERICA

FEDERAL ENERGY REGULATORY COMMISSION

Third-Party Provision of Ancillary )  
Services; Accounting and Financial ) Docket Nos. RM11-24-000 and AD10-13-000  
Reporting for New Electric Storage )  
Technologies )

**Comment of the Staff of the Federal Trade Commission**

September 6, 2012

**I. Introduction**

The Federal Trade Commission (FTC) staff appreciates this opportunity to comment in response to the Federal Energy Regulatory Commission’s (FERC’s) Notice of Proposed Rulemaking (NOPR) on *Third-Party Provision of Ancillary Services; Accounting and Financial Reporting for New Electric Storage Technologies*.<sup>1</sup> The NOPR indicates that third parties seldom provide ancillary services outside of organized wholesale electricity markets,<sup>2</sup> despite procedures that allow sales of such services outside the organized markets at market-based rates.

We read the NOPR in the context of FERC’s concerns about market power and its decision to measure market power primarily in terms of the market share of each firm (including entrants).<sup>3</sup> By contrast, we (and economists generally) expect that entry by innovative, lower-

---

<sup>1</sup> This comment expresses the view of the FTC’s Office of the General Counsel and Bureau of Economics. Although the comment does not necessarily represent the views of the FTC or of any individual Commissioner, the Commission voted to authorize us to file it.

<sup>2</sup> NOPR P 11.

<sup>3</sup> NOPR P 6 explains that the market power concern underlying the NOPR arises because utilities operating under cost-based rate regulation may be able to pass along to consumers the price premiums that third-party suppliers with market power could charge: “The concern in this situation has been that if third parties who had not been shown to lack market power were permitted to sell to public utilities . . ., the public utility’s ability to recover such purchase costs . . . might lead it to agree to above-market purchases . . .”

FERC’s concern may be that entry in this instance will engender unusual price effects associated with collusion among suppliers or with corrupt or imprudent procurement behavior by regulated utilities. We note that many independent generators outside the organized markets are facing new requirements to obtain ancillary services from transmission utilities or to self-supply such services. If FERC decides to order the quality-adjusted pricing of ancillary services, some

cost firms that increases overall market supply will reduce market prices and diminish the ability of all suppliers to exercise market power. In the present matter, potential third-party providers of ancillary services maintain that they lack sufficient access to non-proprietary information to determine the size of the markets for ancillary services – information that is critical to entering with FERC’s permission to charge market-based rates.<sup>4</sup>

FERC anticipated that potential third-party providers of ancillary services would apply for market-based rates and enter the ancillary services markets. Instead, such firms have not entered. FERC has come to understand that its own market power screening process has become a regulatory barrier to competition in this situation. One reason given for the lack of entry is applicants’ reported inability reliably to determine the size of the market. Consequently, potential suppliers of ancillary services may decide that it is too difficult, if not impossible, to correctly complete the process of applying for market-based rates. To address this problem, FERC proposes to change its rules to facilitate entry, with the purpose of reducing the regulatory barrier to competition in ancillary services markets posed by the usual application of its market share screen.

We commend FERC for making it easier for applicants to identify market participants and estimate the size of the market, thereby reducing regulatory barriers to entry into ancillary

---

independent generators may find it advantageous to buy such services from third-party suppliers – such as those discussed in the NOPR – in order to fulfill those new requirements. In all likelihood, these independent purchasers of ancillary services will have strong incentives to minimize costs. State regulators conducting prudency reviews may be able to use the prices that independent purchasers pay as a yardstick to better detect supplier collusion or corrupt/imprudent procurement behavior by regulated utilities. In this way, the components of the NOPR that we discuss in Sections III and IV below are interrelated.

<sup>4</sup> If an applicant for authority to charge market-based rates passes FERC’s market power screen, FERC will undertake a process to grant such authority. FERC uses the applicant’s market share as one of its primary initial screens for market power. (The pivotal supplier test is the other initial screen.) To determine market share, FERC divides the applicant’s size (generally measured in terms of capacity to provide ancillary services) by the size of the market.

In NOPR PP 4-11, FERC discusses the *Avista* and *Ocean Vista* cases, which rely on FERC’s existing market power screens and set the framework for the NOPR. Previous comments by the FTC and its staff have advocated market power analysis that incorporates not only market shares but also other economically relevant indicia of market power. The revised Horizontal Merger Guidelines that the FTC and the Department of Justice issued two years ago (<http://ftc.gov/os/2010/08/100819hmg.pdf>) discuss several of these indicators of market power. As we have done previously (*see, e.g.*, <http://www.ftc.gov/os/2011/06/1106ferchorizmarket.pdf>, *infra* note 8), we continue to encourage FERC to adopt a more complete approach for assessing market power. The use of a more complete approach is likely to sharpen FERC’s ability to gauge market power, to the benefit of consumers.

services markets. Nonetheless, we believe that FERC could pursue this goal even more effectively by hewing more closely to the economic principles that underpin the FTC/Department of Justice Horizontal Merger Guidelines. In particular, FERC's proposed approach likely will continue to impede competitive entry by understating the size of markets for ancillary services and overstating the market power of applicants. By following more closely the economic principles embodied in the Horizontal Merger Guidelines, FERC could further reduce regulatory barriers to entry and provide benefits to consumers in terms of lower prices and improved reliability. We discuss this recommendation in Section III of this comment.

According to the NOPR, FERC also aims to apply the key quality-adjusted pricing reform in Order No. 755 to areas outside the organized wholesale power markets. We agree that recognition of quality differences among ancillary service providers is likely to spur innovation and investment that benefits consumers by reducing costs and increasing service reliability. Section IV below elaborates on this perspective and discusses a specific application of this point.

## **II. Interest of the FTC**

The FTC is an independent agency of the United States Government responsible for maintaining competition and safeguarding the interests of consumers, both through enforcement of the antitrust laws and consumer protection laws and through competition policy research and advocacy. The FTC often analyzes regulatory or legislative proposals that may affect competition or allocative efficiency in the electric power industry. The FTC also reviews proposed mergers that involve electric and natural gas utility companies, as well as other parts of the energy industry. In the course of this work, as well as in antitrust and consumer protection research, investigation, and litigation, the FTC applies established legal and economic principles as well as recent developments in economic theory and empirical analysis.

The energy sector, including electric power, has been an important focus of the FTC's antitrust enforcement and competition advocacy.<sup>5</sup> The FTC's competition advocacy program has produced two staff reports on electric power industry restructuring issues at the wholesale and retail levels.<sup>6</sup> The FTC staff also contributed (as did FERC staff) to the work of the Electric

---

<sup>5</sup> See, e.g., Opening Remarks of the FTC Chairman at the FTC Conference on *Energy Markets in the 21<sup>st</sup> Century: Competition Policy in Perspective* (Apr. 10, 2007), available at <http://www.ftc.gov/speeches/majoras/070410energyconferencereemarks.pdf>. FTC merger cases involving electric power markets have included the *DTE Energy/MCN Energy* (2001) (consent order), available at <http://www.ftc.gov/os/2001/05/dtemcndo.pdf>; and *PacifiCorp/Peabody Holding* (1998) (consent agreement), available at <http://www.ftc.gov/os/1998/02/9710091.agr.htm>.

<sup>6</sup> FTC Staff Report, *Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform: Focus on Retail Competition* (Sept. 2001), available at <http://www.ftc.gov/reports/elec/electricityreport.pdf>; FTC Staff Report, *Competition and Consumer*

Energy Market Competition Task Force, which issued a *Report to Congress* in the spring of 2007 (available at <http://www.ferc.gov/legal/fed-sta/ene-pol-act/epact-fina-rpt.pdf>). In addition, the FTC has held public conferences on energy topics, the most recent of which was *Energy Markets in the 21st Century* on April 10-12, 2007.<sup>7</sup>

The FTC and its staff have filed numerous competition advocacy comments with FERC and participated in FERC technical conferences on market power issues. For example, in March 2007, the Deputy Director for Antitrust in the FTC's Bureau of Economics served as a panelist for a technical conference in Docket No. AD07-2-000 on FERC's merger and acquisition review standards under FPA Section 203. The FTC submitted comments in July 2004 and January 2006 in FERC's proceeding in Docket No. RM04-7-000 on its FPA Section 205 standards for market-based rates. FTC Staff commented on FERC's Analysis of Horizontal Market Power under the Federal Power Act (Docket No. RM11-14-000) in June 2011.<sup>8</sup> The FTC also has commented on FERC's initiatives to promote wholesale electricity competition and on various state issues associated with restructuring the electric power industry.<sup>9</sup>

### **III. Refining the Identification of Market Participants Based on Analysis of Entry**

FERC proposes that the screens for assessing market power in sales of energy also serve as the market power screens for two ancillary services – Energy Imbalance and Generator Imbalance. FERC reaches this conclusion because “[u]nits capable of providing Energy Imbalance and Generator Imbalance do not appear to require any different technical equipment or suffer from any different geographical limitations compared to units that provide energy or

---

*Protection Perspective on Electric Power Regulatory Reform* (July 2000), available at <http://www.ftc.gov/be/v000009.htm> (compiling previous comments that the FTC staff provided to various state and federal agencies).

<sup>7</sup> Conference materials are available at <http://www.ftc.gov/bcp/workshops/energymarkets/index.shtml>. Other programs have included the FTC's public workshop on *Market Power and Consumer Protection Issues Involved with Encouraging Competition in the U.S. Electric Industry*, held on Sept. 13-14, 1999 (workshop materials available at <http://www/ftc.gov/bcp/elecworks/index.shtm>); and the Department of Justice and FTC workshop on *Electricity Policy*, held on April 23, 1996.

<sup>8</sup> FTC Staff, Comment Before the Federal Energy Regulatory Commission on Analysis of Horizontal Market Power Under the Federal Power Act (June 1, 2011), available at <http://www.ftc.gov/os/2011/06/1106ferchorizmarket.pdf>.

<sup>9</sup> See, e.g., Federal Trade Commission, Comment Before the Federal Energy Regulatory Commission on Wholesale Competition in Regions with Organized Electric Markets (Apr. 17, 2008), available at <http://www.ftc.gov/be/v070014b.pdf>. A listing, in reverse chronological order, of FTC and FTC staff competition advocacy comments to federal and state electricity regulatory agencies is available at [http://www.ftc.gov/opp/advocacy\\_date.shtml](http://www.ftc.gov/opp/advocacy_date.shtml).

capacity.”<sup>10</sup> By contrast, FERC observes that “[t]here appear to be significant technical requirements or limitations that apply to the provision of ancillary services other than Energy Imbalance and Generator Imbalance such that the existing market-based rate screen may not be adequate to capture the potential horizontal market power of sellers of these other ancillary services.”<sup>11</sup> This is FERC’s stated reason for limiting the use of its traditional energy market power screens to Energy Imbalance and Generator Imbalance and not extending those screens to other ancillary services.

The NOPR’s discussion of technical requirements or limitations lumps together two different concepts that we recommend FERC consider separately. One concept involves changes in system conditions that may give rise to transmission congestion from time to time. Geographic markets may become smaller when transmission is congested, and the number of suppliers may decrease when this occurs. The second concept is that a lack of equipment or software may prevent a generation facility from providing specific ancillary services. FERC proposes to exclude some potential suppliers from the roster of market participants based on such a lack of necessary equipment. We discuss these distinct concepts separately.

#### Changes in System Conditions Can Result in Fluctuations in the Relevant Geographic Markets

In P 21 of the NOPR, FERC observes that changes in system conditions can determine whether an ancillary service provided at one location can effectively satisfy the demand for that service at a second location. This is one of the essential inquiries in determining the relevant geographic market(s) within which to conduct a market power analysis. FERC’s observation is consistent with the FTC’s position in prior comments and cases about electricity geographic markets more generally (*e.g.*, the *PacifiCorp* matter referenced in note 5, *supra*).

Although we believe that P 21 of the NOPR accurately describes the fluctuations in the scope of geographic markets for ancillary services, this important insight does not appear to permeate the NOPR more generally. For example, NOPR P 15 confirms that FERC’s general approach is to rely on default assumptions about the scope of geographic markets. We encourage FERC to recognize that temporal considerations – *i.e.*, changes in the scope of the market stemming from fluctuations in system conditions – are an important element pervading the entire determination of relevant geographic markets in the electric power industry. Recognition of how geographic markets for electric power can fluctuate in size could help

---

<sup>10</sup> NOPR P 19.

<sup>11</sup> *Id.* P 21.

improve the quality of FERC's analysis and decision-making, both in market-based rate matters and in merger reviews.<sup>12</sup>

Firms that Lack the Specific Equipment Necessary to Serve a Market Should Nonetheless Be Considered Market Participants if They Would Enter Profitably and in Timely Reaction to Supracompetitive Prices

As discussed in the NOPR, FERC concludes that market power screens used for energy markets are not appropriate for assessing market power in some ancillary services markets. NOPR P 17 provides several examples in which a particular generation resource is unlikely to be able immediately to supply a specific ancillary service. As we noted above, P 21 states that “[t]here appear to be significant technical requirements or limitations that apply to the provision of ancillary services other than Energy Imbalance and Generator Imbalance such that the existing market-based rate screen may not be adequate to capture the potential horizontal market power of sellers of these other ancillary services.” P 23 appears to indicate that non-traditional, asynchronous generation resources should not be considered as existing suppliers of Reactive

---

<sup>12</sup> Because electricity demand and supply conditions in one time period are largely independent of those in other periods (due to the lack of storage and inventories), each period can have a different geographic market associated with it. For analytical convenience, periods with similar demand and supply conditions may be analyzed together. Exceptional demand and supply conditions can serve as extremes to use in the analysis of the conditions most and least likely to allow the exercise market power. FERC may then wish to take into consideration the changes in consumer welfare expected to occur under these different conditions. This process involves estimating potential market power under different conditions and the probability that these conditions will occur. Structural or other remedies could be limited to periods when the exercise of market power is likely.

States already use this perspective as a routine matter when they seasonally adjust retail rates to reflect the higher prices caused by transmission congestion (which, among other things, impedes access to lower-priced power from other areas). States can reasonably insist on seasonal differences in rates because similar patterns of transmission congestion recur during certain seasons each year. An example regarding conditional market power mitigation has arisen in an area within the Electric Reliability Council of Texas (ERCOT). Staff of the Public Utility Commission of Texas (with review by the ERCOT market monitor) proposed a voluntary market power mitigation settlement that applies only when specific supply and demand conditions are present. Under the settlement plan, the Public Utility Commission will not allege that NRG Energy has exercised market power (stemming from withholding behavior) if NRG follows specified bidding and selling practices. These “safe harbor” provisions of the settlement pertain to periods in which ERCOT is most concerned about NRG's role as a pivotal supplier in the Houston area – periods when demand or supply conditions create transmission congestion and narrow the relevant geographic market. The settlement agreement is available at [http://interchange.puc.state.tx.us/WebApp/Interchange/Documents/40488\\_1\\_728838.PDF](http://interchange.puc.state.tx.us/WebApp/Interchange/Documents/40488_1_728838.PDF).

Supply and Voltage Control services if they have not installed the electronic controls required to supply these services.

Based on economic research as well as FTC litigation experience, the fact that a potential entrant has not installed a particular piece of equipment may not be a sufficient reason to exclude it from the range of potential suppliers to which customers can turn in response to a price increase (or a non-price diminution of competition). In appropriate circumstances, these potential suppliers should be considered existing market participants.<sup>13</sup> The key question is whether such a firm, *even though not currently producing*, likely would begin meaningful production in a timely fashion in the face of incumbent suppliers' exercise of market power. At one temporal extreme, there could be a very short lag between incumbents' imposition of supracompetitive pricing and meaningful new entry if a potential entrant (a generator) has already nearly installed all of the equipment needed to provide an ancillary service, and the additional cost to enter could be *de minimis*. Similarly, the ranks of existing market participants could swell if one or more enterprising equipment manufacturers could offer quick construction of turnkey facilities on a rental basis in the relevant geographic market(s). FERC's proposed approach counts only incumbent firms' contributions to the size of the market. Where potential entrants participating in the market have a substantial presence individually or in the aggregate, FERC's approach – by understating the size of the market – could significantly overstate entrants' market shares (and presumed market power).

We encourage FERC to refine its analysis to distinguish potential third-party providers of ancillary services that should be viewed as existing market participants from those that should not. In general, a potential entrant that is likely to enter rapidly and profitably should be

---

<sup>13</sup> Section 4 of the Horizontal Merger Guidelines (Market Definition). Section 9 of the Horizontal Merger Guidelines discusses factors bearing on market entry, focusing on the timeliness, likelihood, and sufficiency of entry. Section 5.1 discusses circumstances in which potential entrants should be viewed as present market participants. Where entry by third-party providers of ancillary services would be timely, likely, and sufficient (as described in Section 9 of the Horizontal Merger Guidelines), FERC also may wish to consider granting market-based rates because of the low risk that incumbents could exercise market power. *See, e.g.,* J. Hilke and P. Nelson, *The Economics of Entry Lags: A Theoretical and Empirical Overview*, 61 Antitrust L.J. 365 (1993).

We recognize that FERC may be concerned that viewing some potential entrants as current market participants would allow some incumbent suppliers to pass FERC's market power screens, even though they would fail those screens if the potential entrants were disregarded. The present situation, however, may be even more detrimental to competition because it creates a barrier to entry. Such entry likely would expand supply and diminish the profitability of incumbents' efforts to raise prices. A pilot program applicable to a limited geographic area could test the tradeoff between a more restrictive market power screen and the benefits fostered by lower barriers to entry.

regarded as an existing market participant, and its anticipated capacity, output, or sales volume should be included in the corresponding figures for the entire market. By contrast, for firms unlikely to accomplish such timely and meaningful entry, it is often inappropriate to include their anticipated capacities or sales numbers in calculating total market data.<sup>14</sup>

#### **IV. Expansion of Quality-Adjusted Pricing for Ancillary Services to Areas Outside Organized Markets**

FERC Order No. 755, which recognized that higher-quality ancillary services provide greater system benefits per unit of service, requires that compensation for ancillary services reflect the quality differences among different sources of such services.<sup>15</sup> Order No. 755, however, applies only to organized wholesale markets regulated by FERC. In NOPR PP 47-54, FERC proposes to extend the same concept to wholesale power markets outside the organized markets.

We support this extension. Given that uniform pricing – *i.e.*, pricing that makes no adjustments for differences in quality – constitutes a form of discrimination against quality-enhancing innovations, we favor quality-adjusted pricing of ancillary electricity services. A one-size-fits-all pricing approach favors the technology with the lowest price per unit, even if use of that technology results in higher costs and lower quality in the aggregate. We see strong reasons to expand the application of quality-adjusted pricing to areas outside the organized markets, leading to increased innovation and consumer welfare.

In NOPR P 53, FERC focuses on a particular form of discrimination against quality-enhancing innovations. It concerns the level of reserves required of transmission customers that elect to supply some of their own ancillary services – namely, Regulation and Frequency Response services. If a transmission customer chooses to self-supply an ancillary service, the transmission service provider can require the customer to maintain reserves for such service. Reportedly, transmission service providers outside of organized wholesale power markets typically do not adjust these reserve requirements to reflect differences in the quality of the reserves that the transmission customers maintain. When the reserve requirement is inflexible, a transmission customer lacks the incentive to develop innovations that lead to higher-quality

---

<sup>14</sup> Contributions to competition by potential entrants that are not considered current market participants should be evaluated in a separate entry analysis. *See* Sections 5.1, 5.2, and 9 of the Horizontal Merger Guidelines for a discussion of distinctions between entrants and current market participants.

<sup>15</sup> It is critical to ensure that quality adjustments to prices are justified. Inaccurate quality adjustments can cause inefficiencies that harm consumers. They also can bias innovations and investments toward one or more specific technologies.



Regulation and Frequency Response services. This effect may be particularly pronounced when the higher-quality service happens to cost more per unit, even if the innovation reduces costs in the aggregate. This form of discrimination is likely to deny to transmission customers (and ultimately consumers) the benefits associated with this form of innovation. A system of setting customized reserve requirements that recognizes quality differences among reserves is likely to benefit consumers through increased innovation that lowers aggregate costs and improves reliability. Consequently, we support FERC's proposal to insist that transmission providers adjust reserve requirements for transmission customers to reflect the quality of the reserves maintained by those customers.

In summary, we agree that expanding the coverage of FERC Order No. 755 is warranted. Such expansion is likely to provide incentives in more areas to undertake innovations and investments that will lower system costs and increase system reliability to the benefit of consumers. Thus, we support the proposals in PP 47-53 designed to broaden the geographic reach of the quality-adjusted pricing reforms for ancillary services contained in FERC Order No. 755.