UNITED STATES OF AMERICA
ELECTRIC ENERGY MARKET COMPETITION
INTERAGENCY TASK FORCE
AND THE
FEDERAL ENERGY REGULATORY COMMISSION

Electric Energy Market Competition Task Force	Docket No. AD05-17-000

**COMMENTS OF THE
TRANSMISSION ACCESS POLICY STUDY GROUP
ON DRAFT REPORT**

The Transmission Access Policy Study Group ("TAPS") responds to the Electric Energy Market Competition Interagency Task Force's ("Task Force") invitation to comment on the Task Force's June 5, 2006 Draft Report, 71 Fed. Reg. 34,083 (June 13, 2006). TAPS submitted comments in response to the Task Force's solicitation last fall, 70 Fed. Reg. 60,819 (Oct. 19, 2005),[1] and appreciates the opportunity to review and comment on the Draft Report. TAPS recognizes the significant effort behind the Draft Report and hopes that the report, when finalized, will provide useful direction to the public debate on competition in electric energy markets.[2] TAPS's comments on the Draft Report will be brief and will focus on areas where it believes the Task Force can sharpen the report to increase its value to the public.

TAPS's initial comment is formalistic, but not minor. As described below, the Draft Report contains a number of important, useful discussions, including about the role of transmission adequacy, market participants' need for long-term contracts supported by long-term transmission rights, the role of demand response in making markets competitive, the shortcomings in cost-benefit studies of restructuring, and suggestions that electricity markets

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[1] TAPS's Initial Comments are available at http://elibrary.ferc.gov/idmws/common/OpenNat.asp?fileID=10891097.

[2] The Task Force's efforts are all the more significant in light of the fact, at least as far as TAPS understands, Congress did not provide the Task Force with funding for additional staff or consultants.

today are not competitive. However, many of these issues are not summarized or highlighted in the Draft Report's Executive Summary. Given the reality that busy policymakers may have time to read only the Executive Summary, TAPS urges the Task Force to make it a more comprehensive overview of the body of the final report.

TAPS strongly supports the Draft Report's discussions regarding the important role of transmission adequacy, long-term transmission rights and long-term contracts to ensuring that electricity markets yield supply choices and support investment, particularly in new generation, and the fact that, so far, restructured electricity markets are failing to provide these key elements. *See, e.g.*, Draft Report at 58, 60, 65-66, 69, 71 Fed. Reg. at 34,112-14, 34,115-16, 34,117-18.[3] The fact is that, without assurances of long-term transmission rights, load serving entities ("LSEs") cannot enter into the long-term contracts that investors want to fund electricity infrastructure, whether transmission or generation. TAPS Initial Comments at 5-7. Further, as TAPS's Initial Comments (at 18-19) described, the short-term focus of organized markets designed around locational marginal pricing ("LMP") exacerbates the difficulties of securing long-term contracts at just and reasonable prices.

The Draft Report (at 4, 71 Fed. Reg. at 34,086) correctly concludes that "[b]uilding appropriate transmission facilities may encourage entry of new generation or more efficient use of existing generation." It also cites transmission owner resistance to adding transmission that would subject their own generation to more competition, the difficulties of assessing beneficiaries of transmission for purposes of cost responsibility, and the uncertainty of revenue recovery. *Id.* TAPS's White Paper, *Effective Solution for Getting Needed Transmission Built at*

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[3] The cites herein are to the pagination of the Draft Report on the FERC website and to the Federal Register pagination.

Reasonable Cost, which it attached to its earlier comments,[4] addresses each of the issues. Among other things, it describes (1) how enlarging the pool of potential investors and owners of transmission can get transmission built where existing transmission owners refuse to build; (2) how concerns about who benefits and who pays are most acute if transmission pricing is based upon so-called "participant funding," which attempts to assign to particular market participants the costs of transmission upgrades, even though the upgrades provide broader benefits, and makes little sense in an AC network, and how such concerns are far less important if participant funding is not adopted; and (3) how a number of rate-making mechanisms, such as current recovery of reasonable pre-certification expenses, and inclusion of construction-work-in-progress ("CWIP") in rate base, reduce risk and improve cash flow, without increasing life-cycle costs to customers, and thus address concerns about unpredictable revenue recovery.

TAPS urges, however, that the final report more clearly state its conclusions and identify issues where more information or study is required. The final report can help guide debate about competition in electricity markets and raise important questions that need to be answered, but only if the report points in a direction. For example:

1. Embedded in body of the report, but missing from the opening "observations," is the correct conclusion that transmission is "a necessary adjunct to generation entry" and that "the availability of transmission is often the keystone in determining whether a generating facility is likely to be profitable and, thus, to elicit investment in the first instance." Draft Report at 65, 71 Fed. Reg. at 34,115-16. The Draft Report states (at 66, 71 Fed. Reg. at 34,116):

> Less regulatory intervention in wholesale markets for generation may be necessary if transmission upgrades, rather than high prices

[4] The White Paper is also available at http://www.tapsgroup.org/sitebuildercontent/sitebuilderfiles/effectivesolutions.pdf.

> or capacity credits, are used to address the concerns about future generation adequacy. Although capacity credits may spur generators within a load pocket to add additional capacity, capacity credits may not be required for base-load plants outside the load pocket. Those base-load plants would not have the problem of average revenues falling below average costs because they would have access to more load, and be able to run profitably during more hours of the day. Similarly, price caps may be unnecessary if improved transmission brought power from more base-load units into the congested areas. Prices would be lower because there would be less scarcity, and high cost units would be needed to run during fewer hours.

The Draft Report's discussion implicitly embraces several important points. First, transmission adequacy opens markets for generation, allowing LSEs to contract with plant owners, who then do not need to look to the unpredictable revenue streams associated with price spikes to recover their costs. Indeed, the Draft Report notes investor preference for long-term contracts (at 60, 71 Fed. Reg. at 34,113) and the failure of price volatility to provide steady income and attract investors (at 62-63, 71 Fed. Reg. at 34,114-15). Further, price spikes are hard on consumers, both because most consumers do not want the price for an essential product to reflect the volatility that one associates with a stock market, for example, and because the lack of demand response mechanisms leave consumers powerless in the face of price spikes, especially those triggered by market power exercise rather than genuine scarcity. *See* Draft Report at 40-41, 68-69, 71 Fed. Reg. at 34,105-06, 34,117.[5] Second, as the Draft Report recognizes, the value and effectiveness of capacity payments is similarly suspect as an investment incentive, particularly if

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[5] The Draft Report also appears to conclude too much regarding the ability of price spikes to support generation entry. For example, it notes that following price spikes in the Midwest in 1998, generation investment in the region increased, Draft Report at 51, 71 Fed. Reg. at 34,109-110, but does not set forth evidence, such as the investment prospectuses of the plants that were built, that price spikes were the sole or principal investment drivers. In any event, as a basis for policymaking in the future, the example is not useful. As the Draft Report describes, even generation developers today cite the need for long-term contracts, not price spikes, to support investment. Draft Report at 60, 71 Fed. Reg. at 34,114 (citing Mirant, Constellation). This perspective echoed TAPS's, as set forth in its Initial Comments (at 19-20).

what is needed is transmission investment (or demand response), rather than more generation. Draft Report at 69. Incumbents with plants may resist new generation that either they or others could build, because of the depressing effect the new plants would have on capacity prices and, therefore, their own capacity payments. Further, the organized capacity markets proposed or implemented in the Northeast RTOs all involve complex, administratively determined pricing mechanisms which create risks similar to traditional regulation (Draft Report at 4, 71 Fed. Reg. at 34,086) of getting prices wrong.

2. The Task Force should not hide its conclusions about the quantitative cost-benefit assessments of electric industry restructuring proposals, which are buried in Appendix C of the Draft Report and otherwise not discussed in the body.[6] The Draft Report notes that "both proponents and opponents of electric industry restructuring have armed themselves with these types of analyses to support their respective positions" and further notes the challenge of trying "to understand these studies' sometimes contradictory results." Draft Report at 100. However, the Task Force's conclusions about these studies could help construct future studies that would provide a basis for policy consensus. TAPS appreciates in particular the conclusion that "[m]any of the existing studies address only the benefits of restructuring proposals." *Id.* As TAPS set forth in its Initial Comments (at 15-18), TAPS members have seen first hand the very high and growing administrative and uplift costs in organized markets, which for TAPS members are dwarfing any benefits from the markets themselves. The costs are clear and identifiable. The benefits are speculative, based on assumptions of where energy costs would be without these markets and driven by the level of the "hurdle" rates assumed to be eliminated by restructuring.

3. The Task Force states at the outset that it sought to answer the following question:

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[6] Indeed, the appendix does not appear in the Federal Register version of the Draft Report.

> Has competition in wholesale markets for electricity resulted in sufficient generation supply and transmission to provide wholesale customers with the kind of choice that is generally associated with competitive markets?

Draft Report at 2, 71 Fed. Reg. at 34,085. The Task Force says that it found the question difficult to answer and offers "observations" on which it seeks comments. *Id.* In fact, a fair reading of the entire report is that the answer to the question is "no; at least not so far." The Draft Report describes wholesale customer perceptions that choices in the marketplace are declining or close to non-existent. Draft Report at 58, 71 Fed. Reg. at 34,112-13.[7] Investors and customers express a need for long-term contracts but find that the market is not producing them. Draft Report at 59-60, 71 Fed. Reg. at 34,113. A similar absence of or decline in choices is reported for retail markets. Draft Report, Chapter 4, at 79-94, 71 Fed. Reg. at 34,118-28. Indeed, at least based upon the discussion in the Draft Report, few commentators seem pleased with where the policy of competition in wholesale electricity markets has taken us. Thus, TAPS appreciates that a significant portion of the Draft Report probes the need to encourage investment, but the Task Force should not hesitate to acknowledge the underlying problem: competition is not producing the hoped-for choices.

4. The foregoing comment points to more fundamental issues that the Draft Report does not confront: Are wholesale markets competitive and what are the threats to competitive markets? While the Task Force did not have the resources to undertake to study these questions itself, it should at least put them on the public policy agenda. In fact, the Draft Report contains a

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[7] The Draft Report here (at 58 n.145, 71 Fed. Reg. at 34,113 n.145) observes that "[i]n competitive markets, customers also have the ability to build their own generation facility if they are unable to obtain the long-term purchase contracts they seek." However, a municipal system, for example, with 200 MW of load is not in a position to build its own 1000 MW base load plant. As TAPS pointed out in its Initial Comments (at 14-15), the Federal Energy Regulatory Commission has concluded that self-build often is not an alternative to purchasing. *See AEP Power Mktg, Inc.*, 107 F.E.R.C. ¶ 61,018, P 155 & n.151, *clarified on denial of reh'g*, 108 F.E.R.C. ¶ 61,026 (2004).

number of warning signs that competition is not or will not be sufficient in wholesale markets, including:

- The Task Force states that "the very competitiveness of these markets cannot be assumed" and then describes the Department of Justice's prescient comments from over ten years ago that the "existence of a PoolCo cannot guarantee competitive pricing, since there may be only a small number of significant sellers into or buyers from the pool." Draft Report at 58, 71 Fed. Reg. at 34,113. TAPS pointed out in its initial comments (at 8) that it was and is naïve to expect that merely requiring open access transmission somehow made or would make these markets workably competitive. Yet that appears to be the policy followed by the Federal Energy Regulatory Commission ("FERC"), which has yet to demand significant structural changes, such as divestitures or the construction of new transmission, as a condition for approving market-based rates.[8] Indeed, market power problems are inherent in the locational marginal pricing ("LMP") design that FERC has promoted for organized wholesale markets. Locational pricing, while presumably helping to make more transparent transmission congestion costs, also yields narrow geographic markets in which few generators compete.[9] Thus, an important aspect of the question regarding the sufficiency of competition is if entry (whether through transmission or generation) is succeeding in mitigating the market power of incumbent, dominant firms in load pockets.

- Electricity markets may well need a larger number of competitors to be workably competitive than conventional industrial organization theory predicts. Draft Report at 59, 71 Fed. Reg. at 34,113. Typical concentration analysis would predict that a market with a Herfindahl-Hirschman Index ("HHI") of 1000, the bottom end of the moderately concentrated range, ought to be competitive. However, as the Carnegie Mellon study noted in the Draft Report (*id.*) concluded, even in markets with a significant capacity surplus, 10 equally sized firms can quickly learn to raise prices to monopoly levels.[10] The need for electricity markets to have more rather than fewer competitors is illustrated as well by the fact that relatively small sellers, including ones that might not normally be considered

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[8] *See, e.g.*, Peter C. Carstensen, *Creating Workably Competitive Wholesale Markets in Energy: Necessary Conditions, Structure, and Conduct*, 1 Envtl. & Energy L. & Pol'y J. 85 (2006).

[9] Pages 140 and 142 of the June 2006 Presentation of the Independent Market Monitor for the Midwest Independent Transmission System Operator ("MISO") region regarding the state of the market reported that a large number of areas affected by binding transmission constraints (and thus producing geographic markets separate from other parts of MISO because of the inability of load to look outside of the immediate area for supply alternatives) have pivotal suppliers in many hours of the year. The Presentation is available at http://www.midwestiso.org/publish/Document/7be606_10b7aacd66e_-7d540a48324a/2005%20State%20of%20the%20Market%20Report.pdf?action=download&_property=Attachment.

Mitigation measures for such markets, which in some cases allow prices to rise as high as 200% (or higher) above competitive levels before bids are capped, hardly offer protection to consumers, and the trend at FERC is to increase the harm tolerance thresholds even more. *Southwest Power Pool, Inc.*, 114 F.E.R.C. ¶ 61,289, PP 160, 171, 188 (2006), *reh'g pending.*

[10] *See* Seth A. Blumsack, Jay Apt, & Lester B. Lave, *Lessons from the Failure of U.S. Electricity Restructuring*, Electricity J., Mar. 2006, at 15, 19.

dominant, may be able to exercise considerable market power depending upon the size and composition of their supply portfolios and those units' positions on a market's supply curve.[11]

- The prospect for ensuring the existence of numerous competitors in electricity markets are not presently encouraging. Transmission investment, if it occurs, should help to enlarge the size of geographic markets so that more sellers and more buyers can transact, which should help all market structures, including those with LMP market designs with their inherent market power problems.[12] Disturbingly, however, the Draft Report does not express concerns about the potential for a reduction, rather than an expansion, in the number of competitors in electricity markets. Indeed, the discussion of mergers, acquisitions and power plant divestitures might leave the impression that the industry is becoming less, rather than more, concentrated. Draft Report at 33-34, 71 Fed. Reg. at 34,102-03. Notably absent from this discussion is the impact of the repeal of the Public Utility Holding Company Act of 1935,[13] which is expected to yield more mergers among large utilities across broader geographic areas. Such mergers create the possibility that a small number of large firms will be present in each regional market across the county, which could create opportunities to meet, signal, learn and eventually coordinate their pricing. In addition, the Draft Report mentions generating plant divestitures by Investor Owned Utilities ("IOUs) to Independent Power Producers ("IPP"), Draft Report at 33, 71 Fed. Reg. at 34, 102, but fails to note recent acquisitions of IPP plants by non-divested IOUs (particularly where inadequate transmission allowed the IOU to starve the IPP, forcing it to sell),[14] and indications that the relatively few true IPPs left are interested in consolidating themselves.[15]

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[11] Darren Bush & Carrie Mayne, *In (Reluctant) Defense of Enron: Why Bad Regulation Is to Blame for California's Power Woes (or Why Antitrust Law Fails to Protect Against Market Power When the Market Rules Encourage Its Use)*, 83 Oreg. L. Rev. 207 (2004); Paul Joskow & Edward Kahn, *A Quantitative Analysis of Pricing Behavior in California's Wholesale Electricity Market During Summer 2000*: *The Final Word* 20 (Feb. 4, 2002), *available at* http://www.ksg.harvard.edu/hepg/Papers/Joskow-Kahn%20Final%20Word%20Feb2002.pdf (last viewed June 26, 2006); David Hunger, *Analyzing Gas and Electric Convergence Mergers: A Supply Curve is Worth a Thousand Words*, 24 J. Reg. Econ. 161 (2003); "'Strawman' Staff Discussion Paper on Market Metrics SMD Staff Conference on Market Monitoring," *in Remedying Undue Discrimination Through Open-Access Transmission Service and Standard Electricity Market Design*, No. RM01-12, at 6, 12, *available at* http://elibrary.ferc.gov/idmws/common/OpenNat.asp?fileID= 9567029 (last viewed June 26, 2006).

[12] The LMP theorists also predict that load pockets with high prices should invite new entry. However, often the only potential entrant is the incumbent seller with little incentive to kill the goose that is laying the golden egg. Further, as the Draft Report notes (at 69 n.181, 71 Fed. Reg. at 34,117): "Siting in these areas [load pockets] can be difficult or impossible as a result of land prices, environmental restrictions, aesthetic consideration, and other factors."

[13] Energy Policy Act of 2005, Pub. L. No. 109-58 §§ 1261-1277, 119 Stat. 594, 972-78 (2005).

[14] TAPS Initial Comments at 24.

[15] "M&A: What's Next for Mirant and NRG?," SNL Financial, June 12, 2006, http://www.snl.com/InteractiveX/article.aspx?id=4355158 (last viewed June 26, 2006); Bhattiprolu Murti, *Mirant Rescinds Unsolicited Bid To Acquire NRG*, Wall St. J., June 13, 2006, at A3.

This discussion does not exhaust the challenges to creating competitive electricity markets. Rather, TAPS urges the Task Force to put the issue on the policy agenda by explicitly describing these challenges, and others, in the final report.[16]

TAPS again thanks the Task Force for this opportunity to comment.

Respectfully submitted,

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[16] As an example of the kind of examination that might be desirable for U.S. markets, TAPS recommends that the Task Force review the work of the European Commission, which is investigating the competitiveness of European electricity and gas markets. The reports produced thus far may be found at http://ec.europa.eu/comm/competition/antitrust/others/ sector_inquiries/energy/.