COMMENTARY

POINTS WELL-TAKEN: COMMENTS ON PROFESSOR PETER CARSTENSEN’S PAPER “CREATING WORKABLY COMPETITIVE WHOLESALE MARKETS IN ENERGY”

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Defining market power and dealing with electricity industry structures is maddeningly difficult, which means that the Federal Energy Regulatory Commission (FERC) has a tough job on its hands. To paraphrase Texan Ross Perot: “It’s just not that simple.” Nonetheless, and with apologies to Rob Gramlich from FERC, I am joining the FERC-bashing bandwagon.

My comments on Professor Carstensen’s paper will focus on his discussion of the current efforts, especially of FERC, to regulate the conduct of participants in wholesale electricity markets. As I read his paper, Professor Carstensen is skeptical about the ability of conduct regulation to remedy market power. My experience with this form of regulation leaves me skeptical as well. Structural remedies that expose market participants to the rigors of the competitive market will likely prove more effective at creating workably competitive electricity markets. Unfortunately, it appears that FERC takes a limited view of its ability to implement structural remedies. It therefore has focused its energies on trying to regulate the conduct of market participants. As I will describe later, I am concerned that these conduct-focused remedies leave consumers exposed to competitive harm and do not advance the goal of workably

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competitive markets.

Professor Carstensen describes the kinds of structural changes that should occur to create competitive wholesale markets, namely, separation of the operation (if not ownership) of monopoly services, like transmission and distribution, from the production function, as well as the deconcentration of generation ownership and control. Achieving a structure that supports competition in the electricity market in the United States has proven difficult. In the absence of statutory authority mandating separation of transmission from generation, or divestiture of generation, FERC has had to work with its existing conditioning authority under the Federal Power Act (FPA). It has also sought to persuade—or at times, throw what some call “FERC candy” at market participants to acquiesce to FERC’s vision for the electricity industry.

FERC could do more with its existing authority in some cases. FERC has observed that market-based rates, as opposed to cost-based rates, are a “privilege.” FERC could be more aggressive in describing the conditions that must exist for approval of market-based rates, including a reduction in generation dominance. The seller would then decide whether it wants market-based rate authority enough to accept the demanded conditions such as divestiture of generation or the construction of transmission facilities sufficient to allow competing suppliers to enter a market. Where the seller did not accept these conditions, it would be denied market-based rates. Recently, the D.C. Circuit confirmed FERC’s conditioning authority, finding that if the California Independent System Operator (CAISO) did not meet FERC’s conditions for qualification as an Independent System Operator (ISO), FERC need not approve it as one. Likewise, FERC should identify

4. The court said: If FERC concludes that CAISO lacks the independence or other necessary attributes to constitute an ISO for purposes of Order No. 888, then it need not approve CAISO as an ISO. ISO membership is not an end in itself; it is merely a method jurisdictional entities can use to comply with Order No. 888’s mandate for those entities to file nondiscriminatory open access tariffs.... The Commission, in Order No. 888 and other rulings made pursuant thereto, has defined ISOs according to the terms it wishes. FERC has the authority not to accept something which it does not deem an ISO.

Cal. Indep. Sys. Operator Corp. v. FERC, 372 F.3d 395, 404 (D.C. Cir. 2004). The court specifically recognized the Commission’s power to condition jurisdictional utility rate
structural conditions that an applicant must accept in order for FERC to bless a request to sell at market-based rates.

But I am also cognizant of political realities. When FERC flexes its muscles, even in ways that are supported under the FPA, politically powerful utilities run to their friends in Congress to seek legislative changes that stymie FERC’s efforts; it’s not a pretty sight. FERC’s now officially dead “Standard Market Design” (SMD) initiative, which sought to impose standardized transmission and wholesale electric market design throughout much of the United States, encountered strong resistance in some parts of the country. Utilities in those regions succeeded in having their U.S. senators and representatives include language in proposed national energy legislation that would have delayed FERC’s adoption of SMD by several years. In July 2005, FERC terminated the SMD proceeding. Congress passed energy legislation without the SMD delay after FERC’s chairman went to the Hill touting FERC’s action.

I also want to comment briefly on the title of this panel, “Punishing Market Abuses.” The title suggests punishment of violations of antitrust laws. However, the creation of competitive electricity markets cannot rely upon antitrust law alone. Significant consumer harm can result from the exercise of market power that does not rise to the level of the abuse of monopoly power in violation of section 2 of the Sherman Act. We already have antitrust agencies that worry about such things. FERC has clearly become an actor in a broader field that we might call competition policy, of which antitrust enforcement is a part. I submit that FERC needs to worry about more than just market abuse. It has an obligation to worry about the mere exercise of market power, especially where markets are not workably competitive such that a competitive market response can be counted upon to keep market power in check. Interpreting the obligation under the FPA to ensure that wholesale rates are

filings. Id. at 402 (citing Cent. Ia. Power Coop. v. FERC, 606 F.2d 1156 (D.C. Cir. 1979)).  
just and reasonable, FERC and the courts have stated that market-based rates can only be permitted where a seller does not have or has adequately mitigated market power. 9 Although it does not appear that FERC can limit its concerns to market power abuse, I fear that in practice it has.

For example, in a recent order, FERC distinguished between “warranted” and “unwarranted” exercises of market power. 10 Exactly what FERC means by this distinction is unclear. FERC made the distinction in a context where it stated a policy to ensure revenue adequacy for generating units needed to maintain reliability on the electric grid. It looks as though FERC believes it is acceptable to allow generators, at least those needed for reliability, to exercise enough market power so that they recover their costs without shutting down their units. In a competitive market, perhaps one could categorize some exercise of market power as “warranted” because it would be met and presumably defeated by the competitive response in the market. However, FERC appears willing to apply its warranted market power policy in markets that are clearly not workably competitive, such as load pockets marked by an absence of competitors. 11 If FERC limits its intervention to instances where market power exercise rises to the level of “unwarranted,” I submit FERC has limited its concerns to market power abuse.

In the absence of structural change, FERC has focused on conduct. Professor Carstensen validly observes that “a central premise of much of the current effort to create wholesale markets in energy is that regulating the conduct of existing market participants in these markets regardless of the structure of those markets will suffice to bring about workable competition.” 12 We see this premise in operation in FERC’s approaches to market power.

10. PJM Interconnection, L.L.C., 107 F.E.R.C. ¶ 61,112 at P 18 (May 6, 2004) (stating that “unwarranted exercise of market power” would be more market power exercise than needed to recover necessary revenue).
11. For example, while in competitive energy markets suppliers’ offers should reflect their short-run marginal costs, see infra note 29, FERC has approved rules in markets operated by Regional Transmission Organizations that allow sellers to increase their offers to levels that reflect not only marginal costs but also fixed costs. See, e.g., Devon Power Co., 104 F.E.R.C. ¶ 61,123 at P 2 (2003); Midwest Indep. Transmission Sys. Operator, Inc., 108 F.E.R.C. ¶ 61,163 at PP 308, 317 (2004). Such rules invite bids that exceed competitive levels, infra note 21, which is a perverse result given that the rules are supposed to mitigate market power, not encourage its exercise.
One such approach is FERC’s “Market Behavior Rules,”\textsuperscript{13} adopted in 2003. Professor Carstensen observes that it is possible that there is a belief that if “market participants are told that they must compete that they will do so regardless of their economic self-interest and the opportunities for strategic conduct.”\textsuperscript{14} Such a belief is evident in Market Behavior Rule which stated: “Actions or transactions that are without a legitimate business purpose and that are intended to or foreseeably could manipulate market prices, market conditions, or market rules for electric energy or electricity products are prohibited.”\textsuperscript{15} The remedy for violation of the rule was disgorgement of the profit earned from the violating behavior.\textsuperscript{16} In some cases, FERC threatened to revoke a seller’s market-based rate authorization, though the circumstances under which it would do so were not articulated.\textsuperscript{17} However, simply because FERC says manipulating markets is bad does not mean manipulation will cease. Consider the disgorgement of ill-gotten profits. A rational actor will assess the potential gain from exercising market power, the risks of being caught, and the potential cost of disgorging the ill-gotten gain. Given the low probability of being caught, it is easy to imagine that the gain from undetected exercises of market power will outweigh the cost of the potential disgorgement. A seller’s economic self-interest will prompt it to continue to exercise market power.

Another market power approach used by FERC is the mitigation of excessive bids in areas in the footprint of Regional Transmission Organizations (RTOs) or ISOs where a competitive response is less likely to occur. These areas, referred to as “load pockets,” are typically where transmission constraints require that generation be located “behind” the constraint to serve demand behind the constraint. The regime prevailing in centrally clearing energy markets in New England, New York, and the Midwest features conduct/market impact thresholds.\textsuperscript{18} Under this


\textsuperscript{14} Carstensen, supra note 12, at 114.


\textsuperscript{16} Market Behavior Rules II, supra note 13, at P 129.

\textsuperscript{17} Market Behavior Rules I, supra note 14, at P 139.

\textsuperscript{18} ISO New England Inc., FERC Electric Tariff No. 3, Market Rule 1, Appendix A,
mitigation approach, a seller’s offer into the market is judged against a conduct threshold. For example, the seller’s offer is compared to a pre-established reference level and if the offer exceeds the reference level by a certain threshold, for example, 50% or 300%, the offer is then examined for its market impact using the market impact threshold. If the offer that exceeds the conduct threshold raises the market clearing price by, for example, 50% or 200%, the offer is replaced with the seller’s reference level, which is also known as a default bid. The seller still receives the resulting, recalculated market clearing price.

My concern is that these thresholds leave a lot of room for consumer harm. Prices are allowed to rise 50% or 200% before the seller’s offer is mitigated. FERC justifies the generous thresholds as necessary to ensure that mitigation does not interfere with the functioning of the market. FERC wants to leave room for competitive response so that the market, not intervention in the market, prevents harms from market power exercise. The problem is that these mitigation regimes operate in markets where there is a diminished likelihood of a competitive response. In such cases, the market cannot be expected to protect consumers. However, generous thresholds that allow prices to increase by 50% to 200% mean that market mitigation will occur only in extreme cases of market power exercise. A seller has a strong incentive to raise its offers to just shy of the conduct threshold in order to increase the clearing price while avoiding scrutiny. Indeed, the markets where these mitigation standards apply often have dominant sellers and transmission constraints that limit the ability of competing suppliers to enter, either by directing sales to that market or through new entry.

Such a market is not workably competitive and, absent a structural change, is unlikely to become so.

Another harm associated with this conduct/market impact approach is that it can lead to false conclusions about whether a market is workably competitive. The market monitor looks at the number of times mitigation was invoked and finds few or no occasions. This conclusion is not surprising given the generous thresholds for deciding whether intervention is needed. The market monitor then writes a report that concludes that markets are workably competitive, because there is little or no intervention. I submit that the conclusion that the market is workably competitive is probably wrong, because the market monitor isn’t looking closely enough.

Such false conclusions can reverberate, leading to further weakening of the mitigation regime. In a recent D.C. Circuit decision, the court examined whether automatic mitigation of bids that exceeded the kinds of generous thresholds described above should continue where the market monitor had concluded that the market is workably competitive and FERC adopted the finding. Citing the conclusion that the market was workably competitive and claiming that mitigation in such a market could create substantial injury by curtailing price increases needed to attract supply under scarcity conditions, the court vacated a

of scarcity pricing while preventing any abuse of market power.


25. Id. at 968–69. The court appeared to assume that the New York market remained workably competitive, even during times of scarcity. However, under scarcity conditions, all generation is needed to meet demand, as FERC described recently:

In an auction-type market where participants receive or pay a market-clearing price, suppliers are expected to bid their marginal costs and buyers are expected to bid their marginal value. In some cases, the marginal value of buyers will determine a market clearing price that exceeds the highest marginal cost offer of sellers. In this shortage situation, the higher price will ration available supplies to the buyers who value the supply the most and maintain operating reserves. This higher price would not be the result of withholding and market power, since all supplies would be sold in the market. However, currently in PJM’s real-time market, buyers typically do not submit price bids, and so demand-side bids are not available that can set a shortage price. Under PJM’s existing rules, when there are no demand-side price bids, the energy price is based on the highest accepted supply bid, even if that bid does not clear the market (i.e., equate the quantities supplied and demanded). In these circumstances, one would expect that sellers would submit bids during scarcity conditions that would be above their marginal cost in order to establish a higher price.

PJM Interconnection, LLC, 112 F.E.R.C. ¶ 61,031 at P 88 (July 5, 2005). When all generation is running, there are no other generators who can provide a competitive response, at least in the short term. The only source of price discipline is the demand bids.
FERC order allowing the mitigation to continue. 26

One defense of this regime notes that the establishment of RTOs has made markets broader and enabled more buyers and sellers to reach each other. 27 In theory, this is true, especially in light of the market-enlarging effects of eliminating additive transmission charges. However, what is gained through the elimination of transmission rate pancaking is lost by the adoption of Locational Marginal Pricing (LMP). LMP establishes a clearing price for specific locations in an RTO footprint. Absent transmission constraints, the LMPs throughout a region should be the same. In effect, generators throughout the region are competing with one another. However, when transmission constraints arise, generators within a specific area will not be restrained by competition from the broader market. The generators in the constrained area enjoy an enhanced ability and incentive to raise price above competitive levels. If the generators are not subject to competitive discipline, they should not also have pricing power. Yet, the thresholds described above produce this undesirable combination.

To its credit, PJM’s approach to mitigation where transmission constraints arise seeks to significantly diminish this pricing power. 28 Where an area price separates from the broader region because of transmission constraints, PJM generally limits generator offers to marginal cost plus ten percent. The theory is that in a competitive market, a generator should not be offering at more than its marginal cost because of the risk that it may price itself out of the market if it bids too high, when it otherwise could have made a profitable sale. 29 PJM simply limits the bid to what it should have been in a competitive market. 30 However, the PJM approach came under attack by generators, for example, as preventing prices from rising to

But if buyers cannot submit demand bids, there is no price discipline. Neither the court nor FERC seems to appreciate that under such scarcity conditions where all generation is running, sellers can “establish a higher price” without fear of competitive response. Such a market cannot be deemed workably competitive.


30. Id.
scarcity levels under shortage conditions, which prompted FERC to investigate these accusations.\textsuperscript{31}

PJM and the other RTOs use a uniform price model for their RTO-operated bid market, in which the clearing price is set for the market based upon the bid of the marginal unit. Professor Carstensen correctly observes that:

Control over the price of the marginal unit raises the net revenue of all the other units producing power for sale at that time. Hence, the pricing model employed needs to be responsive to the market context in which sales will occur if the incentive to manipulate is to be limited.\textsuperscript{32}

Something understood at the Antitrust Division was the importance of assessing the supply curve to see who owned units that could set the clearing price. However, if one examines FERC’s stated approach to market power analysis or the market power analyses submitted to FERC by RTO market monitors, one does not find supply curve analyses. The metrics used to analyze market power—variations on pivotal supplier analyses and market share/concentration analyses\textsuperscript{33}—are not up to the task.\textsuperscript{34}

While I disagree with the argument that the existing concentration metrics have limited value,\textsuperscript{35} I do think they need to be complemented with supply curve analyses that help to assess the risk of market harm from small players that might be missed by Herfindahl-Hirschman Index (HHI).\textsuperscript{36}

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\textsuperscript{31} PJM Interconnection, supra note 25. The parties to that proceeding ultimately agreed to a settlement that largely preserves the essential features of the PJM approach. PJM Interconnection, LLC, 114 F.E.R.C. ¶ 61,076 (2006).

\textsuperscript{32} Carstensen, supra note 12, at 122.


\textsuperscript{34} By contrast, as part of this investigation of high prices in gas and electricity markets, despite the opening of those markets to competition, the European Commission recently issued a Draft Preliminary Report in which it noted that “companies with a limited share in generation might have market power at certain moments” and stressed the importance of examining “the distribution of power generation technologies.” Competition DG, European Commission, Energy Sector Inquiry, Draft Preliminary Report, ¶¶ 381, 383, at 119–120 (2006), available at http://www.europa.eu.int/comm/competition/antitrust/others/sector_inquiries/energy/pr_2pdf.


Professor Carstensen further notes that antitrust law has facilitated price discovery systems in markets with many participants but challenged disclosure in oligopolistic markets.\textsuperscript{37} To be certain, concerns over information disclosure could be valid in merger challenges premised on coordinated effects theories.\textsuperscript{38} However, the solution to fears about free-flowing information in electricity markets should not be to keep the information under wraps. Indeed, this approach gives large players with the resources to collect information a leg up on the competitive fringe without such resources. Rather, we need to increase the number of competitors so that information can flow freely with less risk that it will be used to coordinate activity. The resulting better price disclosure would lead to more efficient markets.

The foregoing discussion illustrates that Professor Carstensen’s skepticism of conduct remedies for market power exercise is well-founded. The antitrust agencies have consistently told FERC that structural solutions to endemic market power are better than FERC’s conduct-oriented approach.\textsuperscript{39} Would that FERC follow Professor Carstensen’s and the antitrust agencies’ guidance and use its substantial conditioning authority under the FPA to implement structural remedies?


37. Carstensen, supra note 12, at 125.


39. For example, the Federal Trade Commission itself (not simply its staff) stated:

We continue to believe that structurally competitive markets are generally the best remedy for anticompetitive behavior and existing market power in wholesale electricity markets. We continue to encourage FERC to give high priority to achieving structurally competitive markets while it pursues interim measures, if any, to address findings from its investigations of market conduct.