TheBareEssentials

Market-Based Rate Authority

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Since the 1980s, the Federal Energy Regulatory Commission (Commission) has allowed companies to sell power at market-based rates if the seller and its affiliates have demonstrated that they do not have, or have adequately mitigated, generation and transmission market power; do not engage in affiliate abuse or reciprocal dealing; and lack an ability to create barriers to entry. These elements have made up the Commission's four-prong analysis, which ensures that market-based rates are just and reasonable.

Generation and Transmission Market Power

For the last several years, the Commission has focused on the screen for generation market power, replacing the traditional hub-and-spoke analysis first with the supply margin assessment (SMA) and then with the new two-part indicative screens announced in the April 14 American Electric Power Order. EPSA has expressed concerns about the interim screens and mitigation measures, including the lack of clarity in the new tests; the need for streamlined procedures within RTOs; the complex interplay between wholesale and retail markets; and the problems associated with the new mitigation measures.[1] EPSA has also expressed concerns about the singular focus on generation market power when, in fact, monopsony or buyer market power has been a much larger contributor to the difficulties in achieving competitive wholesale markets.

Now, the Commission has announced the initiation of a rulemaking proceeding to reexamine all four aspects of its market-based rate authorizations. EPSA supports this approach, since it has become clear that other aspects of the Commission's current tests are outdated. For example, today, merely having an Order No. 888 pro forma tariff on file is adequate to pass the screen for transmission market power. However, the potential for dominant transmission providers that operate under open access transmission tariffs (OATTs), but outside of well-functioning RTOs and ISOs, to foreclose access to transmission service by its wholesale competitors and transmission-dependent utilities within their footprint has been recognized by the Commission.

In Order No. 2000 and the Standard Market Design NOPR, the Commission concluded that the open-access transmission tariffs were inadequate to support the efficient and reliable operation of the transmission grid and promote competitive markets. In Order No. 2000, the Commission expressly found that "functional unbundling does not change the incentives of vertically integrated utilities to use their transmission assets to favor their own generation."

Clearly, the interplay of generation and transmission market dominance allows some utilities to effectively foreclose competition, thus undermining the Commission's goal of promoting effective competitive wholesale markets. This foreclosure may be evidenced in any number of ways, including:

- delaying or precluding access to transmission services;
- delaying transmission upgrades or expansions;
- refusing to provide network access to competitors;
- providing discriminatory access to information;
- preferential dispatch of utility or affiliate-owned generation;
- engaging in affiliate transactions that preclude other wholesale suppliers from access to the transmission service necessary to sell to their customers;
- entering into long-term affiliate power purchase agreements (PPAs) that limit the wholesale market opportunities for competitors;
- leveraging market power into adjacent markets; and,
- increasing the financial pressures on competitors.

Examining each prong of the four-prong test will allow the Commission to address on a comprehen-

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[1] Request for Rehearing and Clarification of the Electric Power Supply Association, Docket Nos. PL02-8-000, ER96-2495-016, ER97-4143-004, ER97-1238-011, ER98-2075-010, ER98-542- 006, ER91-569-018, Docket No. ER97-4166-010, May 14, 2004.

sive basis the ability of market participants to exercise market power through generation or transmission dominance. This approach is superior to the current focus on generation market power, particularly in an era of capacity surpluses in many regions of the country and significant monopsony purchasing power. Balancing each prong of the test, rather than placing a primary emphasis on generation market power, is a more robust and accurate way to evaluate market power.

In addition, a more comprehensive review of the Commission's market-based rate program will allow a review of the full range of mitigation methods and market power tests, in light of the current state of market development in various regions of the country.

Organized Markets

EPSA shares the Commission's preference for structural rather than behavioral solutions to market power concerns. Certainly, organized markets give the Commission an initial structural framework from which to identify, examine and mute market power. Companies inside ISOs and RTOs are subject to Commission-approved market monitoring and mitigation measures that provide for organized market scrutiny and evaluation. Consequently, these markets do not need and should not be subject to duplicative mitigation measures. Instead, the Commission should assess the competitiveness of the organized markets on an annual basis, rather than examine market power concerns applicant-by-applicant. This will allow market participants in those markets to avoid unnecessarily exhausting resources on market power analyses.

Outside Organized Markets

Outside of organized RTO/ISO markets, independent regional structures to assist the Commission in monitoring wholesale power markets do not exist. This makes it more difficult to develop a coherent approach to assessing and curbing market power in these regions. In these areas, the Commission needs to renew its focus on all four prongs of the market-based rate assessment. While an established, independent RTO/ISO is clearly the ideal vehicle for implementing market monitoring and mitigation measures, transitional mitigation measures in areas that are not yet served by an RTO/ISO should include having an independent third party: 1) operate and administer the OASIS; 2) be responsible for calculating and posting TTC and ATC; and 3) manage interconnection requests.

Affiliate Abuse

The Commission must also focus attention on the role utilities play as buyers, often the only buyers. This role impacts the third prong of the Commission's market power test: the ability to engage in affiliate abuse and reciprocal dealing. The Commission must guard against the ability of utilities and their affiliates to abuse market power by setting the price, refusing to deal with competitors, engaging in affiliate transactions that unfairly exclude other suppliers or establishing discriminatory terms or conditions in their bidding programs. To mitigate cases of affiliate abuse, EPSA recommends requiring utilities to engage in well-designed competitive procurement practices and to economically dispatch their systems in a manner that allows all generation to compete to serve load.

Barriers to Entry

Any market power analysis must be carefully designed to avoid unintended consequences, including inappropriately limiting the number of suppliers. In general, the more suppliers in a market, the less likely any one entity can abuse market power. Market power should not be a concern unless the party exercising it has the ability to impose a significant and sustained price increase. Therefore, the Commission should be focused on policies that encourage new entry and demand response to discipline prices to those levels that support new entry.

The Commission should be careful not to create disincentives for market entry through the use of mitigation measures that artificially lower price signals for entry at the very time that new entry is needed. That new entry, if encouraged, will bring prices to a competitive equilibrium that will sustain needed resources while assuring consumers of reasonable prices.

The Commission should also focus its attention on transmission planning and expansion processes as a critical component of any barrier to entry screen. The transmission planning and expansion process can be the forum where irrevocable decisions are made about resource alternatives. These processes must be regional, independent, open, transparent, provide an opportunity for input by all market participants and not create any unfair advantage for transmission over generation.