DEPARTMENT OF JUSTICE

STATEMENT

of

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LEGISLATIVE AND OVERSIGHT HEARING ON ANTITRUST ASPECTS OF ELECTRICITY DEREGULATION

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Good morning, Mr. Chairman and Members of the Committee. I appreciate the opportunity to speak to you about some of the competition issues involved in restructuring the electric power industry.

It would be hard to overstate the importance of electric power to the American economy and to American families. Sales of electricity in the U.S. totaled more than $207 billion in 1995, the last year for which final figures are available. All of us have a stake in eliminating obstacles to efficient generation and transmission of electric power.

I believe that bringing competitive market forces more fully to bear in the electric power industry will enable more efficient use of electric power resources, resulting in important benefits for consumers and the economy. Experience has shown that truly competitive markets, when they are achievable, invariably surpass regulation in efficiently allocating resources and maximizing consumer welfare.

Congress has begun looking at what can be done at the federal level to encourage competition in the electric power industry. While I am generally supportive of these efforts, I think it is appropriate to sound a note of caution at the outset. The fact is that there are unique attributes to this industry that will likely make successful competitive restructuring more difficult than might appear at first glance.

In my remarks today, I do not intend to outline a program or offer definitive answers. At this point, the Antitrust Division is actively working with other interested agencies in the Administration to develop the

Administration's position on key restructuring issues. So, today, I will simply highlight what I believe are some important issues that will have to be dealt with if we are to have a successful restructuring effort. After I give a brief overview of our enforcement activity in this industry and the industry's evolution, I will discuss two potential areas for increased competitive benefits: open access transmission and time-of-use pricing. I will also address two potential impediments to effective competitive restructuring: potential market power problems and the matter of stranded costs.

Historical Role 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.

Since that time, now more than two decades ago, we have worked to ensure that the antitrust laws protect consumers of electricity. We have conducted many merger reviews, helped FERC develop its new merger review standards, which now are closely patterned on the joint DOJ-FTC merger guidelines, and been active participants in major FERC rulemaking proceedings involving competition issues. Through these activities, I believe the Division has developed a good understanding of the competitive issues in the electric power industry.

As we move to a competitive generation market, antitrust enforcement will play an even larger role. As our experience with deregulation in a variety of industries over the past two decades shows, when we seek to narrow government regulation and make room for competitive market forces, the industry involved typically responds with a major restructuring of its own. If history is any guide, we could see a wave of electric utility mergers and acquisitions. And we would also anticipate increased temptation -- at a minimum -- on the part of utilities to resort to anticompetitive schemes to ease the competitive pressures of the new market-based environment. It is critically important to have an active and sound antitrust enforcement policy to help ensure a successful transition to competition. The Antitrust Division intends to remain vigilant and active.

The Electric Power Industry

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. Each service area was regarded as a "natural monopoly," because under the existing technology it did not appear economically justifiable to invest in more than one distribution system in each local service area or to construct more generators than necessary to provide full capacity and reliability to that area. Because of these natural monopoly characteristics, state regulators typically required the local utility to supply all consumers in its area, at regulated rates.

Advances in technology over time made power generation more efficient at 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.

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 switched 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.

Increasing Wholesale Competition

Much of the discussion about restructuring the electric power industry has centered around introducing retail competition. That is certainly a desirable goal, but it will not be easy to achieve. Indeed, an essential first step toward achieving competitive retail prices for electricity will be to ensure that we have a well-functioning wholesale market. Although considerable

progress has been made toward this objective, we are not there yet.

We believe that the wholesale market can be made to function even more efficiently than it is currently functioning. Doing so would benefit both wholesale and retail purchasers of electric power, including households and small businesses that use relatively small amounts of power.

Open Access to Transmission

Competition can be most effective to the extent that low-cost generators are able to compete for sales to all potential customers that they can economically serve given available technology. When electric power is supplied by the least costly generators running to full efficient capacity, the overall cost of generating the power is minimized, and prices can be lowered. Such competition by low-cost generators requires open and non-discriminatory access to transmission.

Vertical integration in the same utility of generation and regulated monopoly transmission, however, creates an incentive and ability to impede open access. Because competing generators of electricity will need to use the local utility's transmission facilities in order to supply customers in that utility's service area, the vertically-integrated utility has the ability and incentive to impede competition by favoring its own generators and otherwise restricting competitors' access.

Last year, the Federal Energy Regulatory Commission (FERC) issued Orders 888 and 889, designed to prevent such discriminatory practices.

FERC ordered utilities to separate their generation and transmission businesses functionally, and to abide by a Code of Conduct. FERC's order, which relies on the integrated utilities to engage in conduct that may be inconsistent with their economic interests, may prove insufficient to ensure open access.

Turning over operation and control of transmission facilities to Independent Systems Operators ("ISOs") is potentially a more promising solution for preventing anticompetitive, discriminatory behavior by the owners of transmission facilities. ISOs are regional entities that assume operational control of transmission facilities. Although the current utility transmission owners could retain ownership of their transmission facilities, the ISOs, if governed in a manner that renders them truly independent of the parochial interests of the owning utilities, could ensure comparable and non-discriminatory access to the transmission grid by competing power suppliers. Congress should consider whether FERC needs additional regulatory authority to promote the creation of ISOs.

Open transmission access alone will not guarantee competition in the wholesale market. As long as the transmission segment of the industry remains a monopoly, there will be regulatory issues to deal with regarding transmission rates and rate structures. It is important that transmission prices not be so high as to distort competitive decisions for purchasing power from the most efficient suppliers, and not be so low as to discourage investment in

major new transmission projects to eliminate bottlenecks in the transmission system. The industry and regulators will undoubtedly also face other important issues regarding how to promote expansion of transmission systems to sustain and nurture competitive wholesale markets.

Time-of-Use Pricing

One obvious benefit of increased competition is that it allows consumers to choose a lower-cost electricity supplier. In addition, increased competition can enable certain purchasers to benefit by adjusting their time of consumption in response to price signals. If these purchasers shift some of their use of electricity from peak to non-peak periods, they will reduce the overall costs of acquiring electricity. Lower total demand during peak periods will require less investment in generating facilities and will lower overall system costs.

Congress may want to consider whether current regulation unnecessarily prevents end-users from purchasing electric power directly from a supplier other than their local utility. If end-users are required to purchase power in the retail market at rates based on averaged costs of providing electricity -- which do not fluctuate to reflect the actual cost of producing electricity at different points in time -- end-users lose an important economic incentive to make more efficient purchases of power.

Market Power

It is crucial to address possible market power problems in the

generation market. Historically, of course, vertically integrated electric utilities have typically had monopoly power in their distribution area, and we anticipate that significant pockets of market power may remain even after wholesale competition is widely introduced. This market power stems not only from transmission constraints, but also from high levels of concentration in the generation market. If competition is to take hold in this industry, restructuring of the generation market may be necessary.

Because of the complexities I described earlier in the physics of transmitting electric power through a shared network, market power is maintained and exercised in the electric power industry in complex ways, which may change as we move from a regulated environment to a competitive one.

As a first step, we urge Congress to consider giving FERC the authorization and resources to undertake a thorough study of market power in this industry. FERC not only is the agency most familiar with the industry; it also offers a suitable public forum in which all interested parties may present their views. We would, of course, be pleased to participate in any such study.

We also believe that the federal tools to remedy market power problems where they are found may need to be augmented. The antitrust laws do not outlaw the mere possession of monopoly power. The exercise of market power can be addressed only if an entity is attempting to monopolize, or if two

or more entities are acting in concert in restraint of trade or are proposing to merge. With an industry emerging from decades of government-sanctioned monopoly, we anticipate that there may well be market power problems that do not fit neatly into these categories but are nonetheless serious impediments to competition. Congress should carefully consider whether regulators have sufficient authority to remedy any market power problems, or if federal legislation should further enhance regulatory tools in this area.

Competitively Neutral Recovery of Stranded Costs

Let me now turn to what have been referred to as "stranded costs." As competition lowers prices for electricity, it will become increasingly difficult for utilities to recover all of the capital investments they made under regulation. The historical costs on which utilities will not be able to earn a reasonable return in a competitive market are known as "stranded costs."

There may be many billions of dollars of potential stranded costs at stake here. Not surprisingly, the question of what to do about stranded costs has emerged as one of the major points of controversy in the electric power restructuring debate. There are strong differences of opinion, not only about who should absorb these costs -- the shareholders, the ratepayers, or some broader segment of society -- but also about how to measure them. Should all construction costs incurred during the regulated monopoly era be counted, or only costs that are shown to meet a standard of prudence? How great an effort to mitigate the costs should the utility be required to undertake before

the remaining costs are deemed to be truly stranded? These, and probably others, are important questions.

We are not here to give an Administration position on either how stranded costs should be measured or how they should be allocated. But however stranded costs are measured and allocated, we believe it is important that they be assessed on a competitively neutral basis. By this we mean that they should be recovered in a way that minimizes distortions of competitive choices by wholesale and retail customers. Otherwise, customers could be artificially induced to choose less efficient suppliers, or less efficient sources of energy.

Conclusion

On a final note, I would like to thank you, Mr. Chairman, and this Committee for the important role you played during consideration of the Telecommunications Act, in ensuring that the importance of preserving full applicability of the antitrust laws was not overlooked in the dramatic deregulatory restructuring of an industry occasioned by that legislation. It is equally important that the antitrust laws remain fully applicable to the electric power industry. Any restructuring of an industry is by nature an experiment -- even when it is a carefully considered one. It is thus important to maintain the backstop of the antitrust laws and their 100-year history of preserving and fostering competition.