Mergers and Market Power in the Electric Utility Industry

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Good morning. It is a pleasure to be here today. I appreciate having the opportunity to provide you with some thoughts on mergers and market power from the perspective of one of the many electric utilities that has identified mergers as a way to create value in the changing electric industry.

The 1992 DOJ-FTC Guidelines recognize that merger analysis must consider the conditions in the market being examined. The rather unique conditions and attributes of the electric industry should, in my judgment, be factored into how utility mergers are reviewed. In particular, I would like to make three points today:

(1) Merger analysis should consider the existence of "stranded investment" in the electric industry and FERC's policy allowing full recovery thereof. More specifically, until "stranded investment" is eliminated, merger analysis should focus more on whether the merged utilities will be able to sell at prices above embedded cost, rather than above market prices;

(2) Electric industry market shares and concentration are low in many regions, so merged utilities typically will not have the ability to raise prices; and

(3) Any harmful market power that does exist in the electric industry can be easily mitigated.
I.  **Merger Analysis Should Consider "Stranded Investment"**

As you know, the electric utility industry is moving from pervasive regulation to competition. The desire to move to competition is driven in significant part by the fact that market prices are well below embedded costs. In fact, in many regions market prices barely recover operating costs. Why? Mainly because utilities constructed large generating plants (many nuclear) to meet expected customer load that did not materialize, leaving us with substantial, excess capacity that is discounted on the market.

Some have calculated that embedded costs for existing generating plant will exceed market prices by over $200 billion nationally. This difference is commonly referred to as "stranded investment."

Utilities constructed this existing generating plant under a "regulatory compact," which imposed on utilities an obligation to serve and, in return, provided for recovery of costs prudently incurred by utilities to meet that obligation. For that reason, among others, FERC has concluded (in a rule that is expected to become final tomorrow) that providing recovery of previously approved costs that will become "stranded" (i.e. costs that are above market) is critical to the successful transition of the industry from regulation to competition. Indeed, FERC has determined that full stranded investment recovery is imperative even though it may delay some of the benefits of competition.

How should this history and posture of the electric industry affect merger review analysis? Simply put, until stranded investment is fully recovered, we should not be overly troubled about whether market power will increase competitive market prices.
Rather, the focus should be on whether the merged utility will recover more than its embedded costs. The following graph illustrates the point.

During the transition period to full competition, the total price paid by customers and received by utilities will equal approved embedded costs, and an increase in market price will simply decrease the amount of the stranded investment charge, and vice versa. Moreover, savings generated by a merger are as likely to reduce the embedded cost (and thus customer prices in the short and long term) as market power is to increase the market price (which should not affect overall customer rates). Indeed, most electric mergers today offer rate freezes or guaranteed price reductions.

For these reasons, an increase in market prices resulting from a merger will not permit a utility to unduly profit. Note in this regard that Pennsylvania Power & Light
cited stranded investment concerns as a primary reason for rejecting PECO Energy’s merger offer (which included a stock price premium of almost 50%). It seems that PP&L was concerned that the merged entity would not be able to recover its costs as previously approved by regulation -- that is that the merged entity would actually lose profits.

Ironically, though, mergers are one of the last remaining tools available to the electric industry to obtain true efficiencies and savings that can be applied to reduce stranded investment -- and to decrease prices. Other available savings have largely been realized (for example, PECO Energy has cut its employees and contractors from nearly 14,000 to 7,000 over the last six years).

Perhaps, then, electric utility mergers should actually be encouraged as a partial solution to stranded investment, or as a way to lower prices in the long run, even if they increase “market prices” during the short term. In this regard, the DOJ-FTC Merger Guidelines themselves recognize that efficiency gains can offset the competitive risks of a merger.

What about, say, 10 years down the road, after stranded investment has been recovered and the transition to full competition is complete? The situation will be quite different, and any market power that is created by a merger today is likely to have dissipated, for several reasons. Excess capacity today will, during the transition, be committed to meet growing customer demand, and thus utilities will not be able to withhold that capacity from the market or use it to manipulate market prices. In addition, utilities will retire units, and at the same time most new generating capacity
will be built not by utilities but rather (as is the case today) by independent power producers, thereby further reducing concentration. Finally, market prices will be capped at the cost of inexpensive new generating units with short construction lead times -- for example, gas-fired combined-cycle units. In other words, entry will protect against the exercise of market power.

II. Merged Utilities Will Have Little Ability To Raise Prices, Given That Market Shares And Concentration Are Low In Many Regions

The inclination may be to assume that merged electric utilities will have market power. They are, after all, "monopolies" in their local retail territories. That assumption, however, is incorrect.

The U.S. electric industry is characterized by many interconnected firms with small market shares in the relevant markets. There are well over 300 public utilities (including power marketers and over 100 investor-owned utilities). Most regions have low market shares and concentration.

For example, in the Mid-Atlantic region, in which PECO Energy participates, wholesale competition is fierce. Over 60 entities sell power in the bulk-power market. The largest supplier controls only around 17% of the uncommitted capacity, and the HHI is well under 1000. Perhaps more importantly, many sellers chase the same limited opportunities (witness the huge number of bids received in response to RFPs); any number of sellers can individually serve a large portion of the growing load, thus protecting against the exercise of any market power by firms with larger shares.
The geographic scope of this market is huge -- from Illinois to Canada to New England to the Carolinas. Every one of the utilities shown on the map below has actually participated in transactions in this regional market.
This market is expected to become even more competitive. The Pennsylvania-New Jersey-Maryland Power Pool members are working to implement regional transmission service and establish an independent system operator. These changes will not only remove any vertical market power that could arise from control of transmission, but also will expand the geographic market and facilitate participation by new entities. Similar changes are being implemented all over the country, particularly as a result of FERC’s rule requiring that all utilities have in place open-access transmission tariffs.

Therefore, wholesale competition is vigorous, and there is every reason to believe that retail markets will be just as competitive if they are deregulated.

With respect to concentration, I would finally note that the current fragmented electric industry structure, with hundreds of suppliers, is almost certainly not the optimally efficient structure. That becomes obvious when the structure of other similar deregulated and heavy industries is examined (e.g., telephone, railroad, airline, automobile). Regulation has constrained what would otherwise be a more natural electric industry structure. Now that regulation is giving way to competition, a more appropriate structure, formed through mergers and the creation of new entities (e.g. power marketers) will evolve. I believe we ultimately could see vertical disaggregation (separation of the transmission and distribution “wires” business from generation) and horizontal aggregation. In any event, it appears as though electric business combinations are inevitable, and desirable.