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## FERC Reconsidering Horizontal Market Power Analyses For Purposes of Section 203 Filings and Market-Based Rate Applications

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### **Executive Summary**

On September 22, 2016, the Federal Energy Regulatory Commission (“FERC”) issued a Notice of Inquiry (“NOI”) seeking comment on whether FERC should make changes to the manner in which it evaluates horizontal market power for purposes of evaluating transactions under Section 203 of the Federal Power Act (“FPA”) and its market-based rate program. Among other things, if FERC ultimately adopts this proposal, certain transactions that currently require no detailed market power analysis to be submitted in order to obtain approval would now be subject to more scrutiny. For instance, while FERC traditionally has not required applicants to submit a detailed market power analysis where a transaction would result in a *de minimis* change in market concentration, the NOI suggests that FERC is reevaluating the merits of this approach where the transaction involves the partial acquisition of a competitor’s assets in a particular market or serial acquisitions by a company. For example, a merchant generation holding company might propose to sell its generation operating company subsidiaries in a particular region to another entity with ownership and control of merchant generation in the same market. Applicants for such transactions may now need to include a detailed analysis, likely requiring more time to prepare the application and longer approval time. More significantly, FERC is proposing to examine the effect of proposed transactions on capacity markets more closely. Specifically, FERC seeks comment on whether to require a supply curve analysis, which evaluates the ability and incentive of a merged company to exercise market power by withholding marginal units in order to increase profits generated by baseload generation. As proposed, such a supply curve analysis would focus on the quantity of marginal and infra-marginal capacity that would be controlled by a company following a contemplated transaction. Until now, FERC’s merger review has been primarily focused on energy markets rather than energy *and* capacity markets. The proposal to require applicants to provide analyses of the effect of certain proposed transactions on the market for capacity could reflect FERC’s recognition of the consolidation that has been taking place among the existing independent power producers and the possible effect of that consolidation on the capacity markets in certain organized markets.

In addition, and among other things, FERC is considering whether to establish a dollar threshold on the need to obtain authorization pursuant to Section 203(a)(1)(b) for certain jurisdictional asset transfers. FERC transmission owners have previously and informally communicated their support for this type of modification. If FERC adopts this particular proposal, certain public utility asset acquisitions that currently require prior authorization from FERC would not need to go through the cost and delay of a formal Section 203 approval process. For example, many interpret FERC's requirements to trigger prior authorization pursuant to Section 203 for transmission utilities to acquire discrete transmission equipment such as breakers, transformers, switches, and associated structural steel equipment. As proposed, the acquisition would need to total \$10 million in order to trigger the FERC authorization requirement.

FERC is also asking for comment on the market power analysis it considers in the market-based rate context and looking to harmonize those Section 205 (rate) requirements with Section 203 (transaction approval) requirements. For example, FERC is concerned that its pivotal supplier test in the market-based rate context is most typically passed (*i.e.*, possibly too "easy" to pass) and, thus, may need to be revised and strengthened.

In sum, FERC's proposals could impose significant new filing requirements on certain Section 203 applicants seeking FERC authorization for mergers, acquisitions and other transactions, and make it more difficult for certain utilities seeking market-based rate authorization to demonstrate that they do not have market power. We provide further detail on all of FERC's proposals below.

## **Discussion**

FERC's analysis of horizontal market power is a critical component of FERC's Section 203 and market-based rate programs:

- FERC currently requires an applicant seeking Section 203 authorization for the proposed disposition, consolidation, acquisition, or change in control over a utility or FERC-jurisdictional assets to submit a Competitive Analysis Screen, based on the Department of Justice ("DOJ") and Federal Trade Commission's ("FTC") 1992 Horizontal Merger Guidelines, to demonstrate that a proposed transaction will not have an adverse effect on competition. As part of the Competitive Analysis Screen, applicants will submit a delivered price test ("DPT") analysis analyzing the relevant market and evaluate market concentration using the Herfindahl-Hirschman Index ("HHI") consistent with the thresholds established in the 1992 Merger Guidelines. The HHI analysis is a widely used measure of market concentration that is calculated by squaring the market share of each firm competing in the market and summing the results. FERC allows applicants to forego the submission of a Competitive Analysis Screen if: the transaction would not result in any increase in the amount of generation capacity owned or controlled collectively by the applicant and its affiliates in the relevant market; or the applicant shows that the transaction would result in a *de minimis* change in market power. FERC also has established

blanket authorizations that grant pre-approval for certain types of transactions without requiring the separate submission of a Section 203 application.

- In the market-based rate context, FERC requires applicants to submit two indicative screens to demonstrate that they do not present horizontal market power concerns: a market share screen that evaluates whether a seller has a dominant position in the market by comparing the uncommitted capacity owned or controlled by a seller and its affiliates to the uncommitted capacity to the market as a whole; and a pivotal supplier screen that evaluates a seller's market power in peak periods by considering whether the capacity of the seller and its affiliates is needed to serve wholesale load, excluding sellers' native load obligations, in peak periods. A seller that passes both screens is presumed to lack horizontal market power in the relevant market.

FERC's NOI seeks comments on potential modifications to the following elements of FERC's existing Section 203 and market-based rate analyses:

- **De minimis threshold:** FERC requests comments on several proposed changes to its approach to determining whether a transaction is *de minimis*:
  - FERC requests comment on whether it should establish a bright-line threshold for a transaction to be considered *de minimis* such that the submission of a Competitive Analysis Screen should not be required. FERC explains that it has accepted various representations made by applicants regarding why a particular transaction should be considered *de minimis* and that many applicants will provide a simplistic calculation referred to as the "2ab analysis," which compares the installed capacity of the parties to the transaction to the market size as a proxy for the likely change in HHI from the transaction. The 2ab analysis multiplies 2 with the percentage market share of each of the two merging entities. Factoring in the concentration of the market, the result of the calculation has been relied on to demonstrate that no adverse effect on market power would result. FERC states that it is considering establishing a bright-line threshold that would be compared to the pre-transaction market shares of the two parties to a contemplated transaction.
  - FERC further requests comments on whether the 2ab analysis may not accurately identify whether a transaction presents competitive concerns when an applicant is seeking to acquire part of the assets of a competing firm in a relevant geographic market. FERC explains that, "where both entities will continue to exist post-merger . . . relying on the algebraically simple 2ab analysis may be inappropriate because the resulting market shares of the post-transaction competitors have changed and therefore the squared market shares caused by the transaction do not produce the same mathematical result as when two firms merge."

- In addition, FERC seeks comment on whether it should take into account incremental acquisitions by a company in the *de minimis* analysis. Expressing concern that serial acquisitions by a company may allow the company to amass a significant market position without requiring the submission of a full Competitive Analysis Screen, FERC requests comment on the extent to which serial acquisitions should be taken into account in its competition analysis and evaluation of whether a transaction is *de minimis*.
- **Supply Curve Analysis:** FERC also seeks comment on whether to require Section 203 applicants to submit a supply curve analysis, which evaluates the ability and incentive of a merged company to exercise market power by withholding marginal units in order to increase profits generated by baseload generation. While the existing HHI analysis focuses on market concentration, a supply curve analysis focuses on the quantity of marginal and infra-marginal capacity that would be controlled by a company following a contemplated transaction. In order to obtain a more complete picture of the potential competitive implications of a transaction, FERC states that it is considering requiring a supply curve analysis for each section 203 application that requires a Competitive Analysis Screen.
- **Pivotal Supplier Analysis:** In the NOI, FERC expresses concern that its pivotal supplier screen underestimates the ability of sellers to exercise market power by employing unrealistic assumptions regarding the ability of remote sellers to serve load and reducing peak load by native load obligations. Noting that sellers rarely fail the pivotal supplier analysis, FERC requests comments on whether modifying the existing pivotal supplier analysis by including consideration of native load or making other changes would improve the accuracy of the analysis or result in “false positives” that could significantly increase the burden on market-based rate sellers.
- **Harmonization of Section 203 and market-based rate analysis:** FERC also seeks comment on whether it should incorporate a version of the pivotal supplier and market share analyses employed for market-based rate purposes into its Section 203 analysis. FERC notes that it believes that incorporating the pivotal supplier and market share analyses into its Section 203 analytical framework may provide a more complete picture of an applicant’s position in a market.
- **Blanket Authorizations:** FERC states that it is considering whether certain of the blanket authorizations are no longer appropriate due to industry changes since they were first established. For instance, FERC observes that it may no longer be appropriate to grant blanket authorizations to holding companies that only hold interests in exempt wholesale generators (“EWG”), as EWGs now make up a significant portion of wholesale supply. For that reason, FERC states that it is seeking comment on whether there are existing blanket authorizations under Section 203 of the FPA that may no longer be appropriate.

- **Threshold for Transactions Triggering Scrutiny under Section 203(a)(1)(B):** While certain provisions of Section 203 include a “minimum threshold” of \$10 million for transactions requiring FERC approval, Section 203(a)(1)(B) provides that a public utility must seek FERC authorization before it merges or consolidates its jurisdictional facilities with those of another person, without any minimum dollar threshold. FERC observes that the lack of a monetary threshold for mergers and consolidations has resulted in applicants seeking approval for transactions that do not pose competitive concerns and seeks comments on whether there are categories of transactions falling within the scope of Section 203(a)(1)(B) that should be subject to abbreviated filing requirements.
- **Capacity Associated with Power Purchase Agreements:** Currently, where a Section 203 applicant seeks to acquire an ownership interest in a generation facility that it controls pursuant to an existing power purchase agreement (“PPA”), FERC attributes the capacity of the facility to the applicant’s pre-acquisition market share. In the NOI, FERC expresses concern that this approach may fail to take into account the long-term competitive implications of the acquisition, including that the transaction may prevent competitive supply from reentering the market upon expiration of the PPA. For that reason, FERC seeks comment on whether it should use alternative methodologies in its review of Section 203 applications to account for the capacity associated with long-term firm PPAs.
- **Filing of Merger-Related Documents:** Noting that applicants seeking merger authorization from the DOJ and FTC often will submit analyses addressing the competitive effects of the merger prepared by the company or its consultants, FERC requests comments on whether FERC should require the submission of such analyses as part of any Section 203 application. While FERC states it would continue to rely on the results of the Competitive Screen Analysis when determining whether to grant Section 203 authorization, FERC states that it believes requiring the submission of such documents may provide FERC with additional context that it can use in understanding the Competitive Analysis Screen.

Comments on FERC’s proposals are due within 60 days of the NOI’s publication in the Federal Register. Once comments are submitted, it is likely that FERC will issue a Notice of Proposed Rulemaking identifying any changes that it plans to pursue in light of the comments received. It is also possible that FERC may elect to withdraw the NOI and reaffirm its existing policies as it did several years ago after issuing an NOI proposing modifications to its horizontal market power analysis for Section 203 and market-based rate purposes.[1]

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[1] *Analysis of Horizontal Market Power under the Federal Power Act*, 138 FERC ¶ 61,109 (2012).