

Presentation by Jonathan Falk
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I want to thank the Commission for the opportunity to share my views on when and how the Regional Transmission Organizations should deal with local market power concerns. First, however, let me say that my presentation is being sponsored by the marketing and generating organizations of PPL Corporation. PPL is a member of PJM and one of its original founders. It operates several generating units in PJM that have been subject to offer-capping and one in New England, the Wallingford facility, with which I suspect the Commission is somewhat familiar. PPL also owns and operates generation in Maine, New York, Montana and Arizona and distributes electricity to 1.3 million customers in central eastern Pennsylvania.

I want to focus my remarks today on the first question posed by FERC with its technical conference agenda: What is local market power and why should it be mitigated? I have come to the conclusion that a lot of the controversy this question has caused is a direct result of not really thinking about this question in the appropriate context. The insight I've had (and I hope you will agree it's a useful one) is that local market power is simply the ability to collect a locational rent, that is, it's an opportunity for economic profit that flows from the fact that certain units at certain times are much more valuable than other units. Their value stems from the fact that without them, the reliability of service is threatened, and reliability is very, very valuable.

There is no other rent that we don't allow generators to try and capture. If they can generate very cheap power, we let them capture the difference between their costs and the market price. If they have savvy trading operations, we let them earn as much profit as they can on that operation. If they have signed contracts that turn out to be priced above market price over time, we let them keep those profits.

Why do we even call these locational rents market power? I think the reason is that we have been too focused on the technical definition of market power as the ability to affect price. This definition is not helpful as a practical guide in two respects: first, to be accurate it must be conjoined with a notion of sustainability, i.e. market power is an ability to significantly affect prices which cannot be thwarted by entry or by actions of other current market participants. We focus on affecting price but tend to wave our hands on considering the effect of entry on the sustainability of the price increase, except to sometimes assert that entry would take "too long," whatever that means.

But the second reason is even more pervasive. We don't really ask what it means that the unit in question can affect price. The only reason it can affect price is that its output is more valuable than another unit's output to fulfill a local reliability function. This is a good thing, and it ought to be encouraged with at least some level of rents to induce others to enter and attempt to capture those rents.

Why do some think locational rents are different than rents that come from fuel cost differences, or favorable ramp times or any of the other host of things which make some generators perform better than others? They cite three reasons: 1) the rents which are earned from location aren't really earned: they represent historical accident and thus would just be a windfall to the person who happens to own the unit; 2) load pockets really are not readily susceptible to new entry; or 3) the loads inside the load pockets are captive customers who deserve protection. None of these reasons, however, are without weaknesses that, when carefully considered, undermine their superficial appeal considerably.

First, even if the initial distribution of these rents may be accidental (and for recently constructed generators in expensive load pockets, like PPL Wallingford they should not be considered accidental), the whole point of generation competition is to generate a better pattern in the future. Leaving some level of rents out there for generators to potentially capture is the price we pay for dynamic efficiency, just as all the other rents which a generator can earn from, say, a reduction in his heat rate will promote innovation.

Second, while there may be some load pockets in which the barriers to entry really are structural, we really know very little about what changes to transmission infrastructure or what entry decisions could completely eliminate the incumbent generator's locational rent. The New England PUSH bidding experiment is quite instructive in this regard. If units could not earn their PUSH bids, it must be that they weren't as required for reliability as we might have thought *ex ante*. Competitive systems are very, very good at arbitraging rents. We ought to at least give them an opportunity to try.

Third, as to the protection of captive customers, if the barriers really aren't structural and if competition really can solve these problems, the customers should need no more than temporary protection. And to achieve the dynamic effects, we have to loosen the constraints on price. The line between gouging and incentives is one that regulators will have to draw, but it makes no more sense for customers to keep these rents than generators. And if we use the analogy of market power to try and cap these prices at short run variable costs, we should not fool ourselves into thinking that we are doing anything other than allowing loads to capture these rents. By allocating these rents to consumers at the expense of generators, we not only give no incentive for anyone to relieve the constraint through new investment or load response, we actually give consumers incentives to locate within the load pockets and make the problem worse.

So the upshot is, the operation of the electric system is producing locational rents. Whether regulators have realized it before now or not, they are going to have to decide how to allocate the locational rents. That is a simple fact. Giving some of those rents to generators, i.e. allowing them to use some of their so-called "market power," is the only way to keep these temporary problems from becoming permanent.

As a final point: if we decide for whatever reason that a load pocket is chronically in need of mitigation, we would be better served finding a market mechanism to replace indefinite administrative oversight. The proposed PPL auction mechanism provides the necessary fallback mechanism in those remaining situations that markets cannot correct.

I would like to thank the Commissioners, Commission Staff and those of you in the audience for the opportunity to speak today. I will look forward to answering any questions at the appropriate time.