Report to the Mississippi Public Service Commission on Issues in Retail Market Power

by

Michael T. Maloney, Ph.D., & William F. Shughart II, Ph.D.¹

on behalf of

Utility Management Corporation
&
Mississippi Manufacturers’ Association

1) Introduction

The purpose of this report is to comment on the studies filed by Mississippi Power Company (MPCo) and Entergy Mississippi, Inc. (EMI) in response to the Commission’s request for market power studies in Docket No. 96-UA-389.

In general, both studies predict that there will be no market power in a competitive electric industry in Mississippi. That conclusion is based primarily on an analysis of the economic dispatch of electricity generation facilities in the proximate and not so proximate regions of the country. While the study by Mr. Frame for MPCo touches on the question of vertical market power, neither study directly addresses the issue of market power in customer access. We think that this is the major gap that must be addressed by the Commission, and this is the issue on which we focus most of our comments.

2) Definitions

The MPCo study does a good job of defining the various terms and economic concepts involved in the question of market power. Without belaboring the point we review some of those concepts here.

a) Market Power

Market power refers to the ability of a seller (or a group of sellers acting in concert) to charge prices that exceed the cost of production. Consumers are harmed by the exercise of market power because they pay a higher price than they would pay in a competitive setting. Consumers are also harmed because they lose the opportunity to purchase units of the product, and they are willing to pay more for these units than it costs to produce them.² In raising its price, the seller with market power simultaneously offers fewer units for sale than it would offer in a freely functioning competitive market environment.

¹ Professor of Economics, Clemson University, and Barnard Distinguished Professor of Economics, University of Mississippi, respectively.
² The biggest social loss due to monopoly is the fact that the value consumers place on the product is greater than the cost of producing the product.
In open market environments, rivals quickly take advantage of the profit opportunity that appears when one firm sets its price above cost. In doing so, rivals produce and sell the units not sold by the firm aspiring to market power. By increasing supply and undercutting the above-normal price, these rivals, motivated by the prospect of capturing profits for themselves, expand output to competitive levels and force price down to cost. Hence, market power can persist only when markets are not open, that is, when barriers to entry prevent new rivals from filling the demands left unfilled by an artificial restriction in output.

b) Barriers to Entry

The barriers that prevent competitive rivalry from stopping the exercise of market power may come from several sources. One is government regulation. Sometimes government itself creates the potential for market power by granting one firm the exclusive right to serve a market. In this case, exemplified by so-called natural monopoly, it is the concurrent duty of government to limit the exercise of market power by regulating the price that the service provider can charge within its exclusive franchise area. This is the current status of the retail electric industry.

Another potential barrier to entry is the scale of production. If there is a minimum efficient scale of production that companies must achieve in order to produce at the lowest cost, a monopolist may effectively be able to create a barrier to entry by preventing rivals from gaining a significant foothold in the market. In this way, a firm may be able to exercise market power and at the same time protect its monopoly. It can raise price above its own cost of production but not raise it above the production cost of potential rivals because they have higher costs. Rivals’ costs are higher because they are not able to capture a large enough share of the market to achieve minimum efficient scale.

A third barrier to entry that is especially of concern in the competitive electric industry is foreclosure of the market due to restriction of access to a required resource. Electric generation can only reach the market over transmission and distribution wires. To the extent that transmission resources are withheld from potential suppliers or made available, but only on unfavorable terms, a barrier to entry is created.

Barriers to entry can sometimes be lowered by deregulation or by structural remedies such as divestiture of assets or separation of lines of business.

c) Market Concentration

A central focus of the analysis of market power is the identification of the boundaries of the relevant market within which competitive conditions will be assessed.³ Definition of the relevant market, in turn, involves the fairly straightforward task of identifying the alternatives to which consumers can turn if faced by an increase in the price charged by one seller or group of sellers. These alternatives consist of other products that are reasonably substitutable for the one whose price has been increased, other sellers who market the same product at different geographic

locations, or both. The set of products among which consumers can freely substitute defines the relevant product market and the boundary of geographic area that encompasses all of the sellers who now sell the same product or closely substitutable products (or could sell there in the event that the local price is increased) defines the relevant geographic market.

The more alternatives there are available to consumers, the less likely it is that any one firm will be able to raise its price and profits at consumers’ expense. Hence, the scope of the relevant market, properly defined, helps determine the extent to which any one seller within that market possesses market power. At one extreme is a market served by a monopolist – a single firm that produces a product with no close substitutes. Such a firm can raise price unilaterally without fear that rivals will compete his profits away. At the other extreme is a perfectly competitive market – a market served by so many sellers that no one of them has any power over price. Most actual markets fall somewhere in between these two extremes. Thus, a key question for antitrust law enforcers and regulatory policy makers is, How concentrated must a market be in order for the balance to tip from competition to market power?

Market concentration is the degree to which the market is controlled by one or a few firms. If 80 percent of the sales in a market are made by one firm, the market is concentrated. If the four largest firms together sell only 20 percent of the output in a market, then the market is not concentrated. Market concentration heads the list of symptoms to look for in diagnosing market power because the greater is a firm’s share of the relevant market, the larger is its share of the benefits of restricting output.4 There are many different ways of calculating market concentration. The standard measure now used by the U.S. Department of Justice and the Federal Trade Commission is the Herfindahl-Hirschman Index (HHI). Mr. Frame presents an informative discussion of the HHI on pages 22-25 of his report. As he points out, the antitrust authorities treat market concentration of 1800-2500 on the HHI scale as the trigger point for the presumption of market power. Generally speaking, if there are between four and six equally sized firms serving a market, the market is not considered to be concentrated and the presumption is that there is no threat of the exercise of market power.

3) Issues in Market Power in Generation

The question of market power in generation is actually composed of two parts. These can be characterized in terms of horizontal and vertical market power. The horizontal market power question is, Do either or both of Mississippi’s investor-owned utilities control such a large share of the generation resources in the relevant geographical market that they can restrict output and cause market price to rise? On the other hand, vertical market power may arise from the fact that the owners of the transmission system are also the owners of generation resources. Whether or not the utilities have market power in generation, they may be able to effectively monopolize the generation market by their control of transmission resources necessary to allow competing supplies of generation to reach the market.

4 Ibid., p. 17.
a) Horizontal Market Power in Generation

Both utility studies address market power in generation capacity by employing a dispatch model created by Henwood Energy Services, Inc. The Henwood model appears to be a fairly straightforward model of generation and transmission capacity linked to the time path of electricity usage (load) during each hour of the year. In other words, a forecast of potential electricity usage is created from past consumption levels. This forecast estimates electricity load for each moment in time for a whole year. The generation plants and transmission lines in place are then allocated to serve this load. This allocation is done so that the lowest cost plants are dispatched to serve the load at each moment.

The Henwood model is used to address the question of market power in two ways. First, the model shows the percentage of the generation market controlled by the two different companies. This is just simple market share analysis and does not really need the Henwood model except that it details all the generation sources in the relevant area. Second, the model is simulated for the exercise of market power.

In the market power simulation, the model is run in its base-case scenario. Then plants owned by MPCo and EMI are backed down so that they generate less power. With less power on the grid, the wholesale price of power goes up. However, there is a competitive effect. As MPCo or EMI reduce their generation, other plants around the country increase production and make up some of the difference. The question raised is whether either MPCo or EMI can reduce its output enough to affect market price significantly and profitably. The conclusion of both studies is that neither company acting on its own can profitably affect market price.

i) Critiques of the Utility Studies

While a large number of scenarios are considered, only a few of them are relevant to assessing the market power that may potentially exist in a deregulated retail market environment. Consider Table 2 in the MPCo study. Half of the estimates of market shares and market concentration indexes presented there assume that Southern Company and Entergy affiliates located in neighboring states will significantly constrain the exercise of market power in the relevant geographic market, defined by Mr. Frame as the combined territories now served by EMI and MPCo. That is, these scenarios assume that other Southern Company and Entergy affiliates will respond to an attempt by either EMI or MPCo to increase the price of electricity in the relevant market by dispatching more power to Mississippi, thereby defeating their own local affiliate’s attempt to increase its (and their parent company’s) profits at consumers’ expense. That assumption is implausible.

Hence, the structural and behavioral analyses of most interest are those in which all Entergy and all Southern Company generation facilities are treated under the singular control of the two parent companies, respectively. The estimates are shown in rows II.B and II.D of Table 2 (and in detail in Tables 8 and 10). Those entries answer the question, What is the possibility of market power if the Southern Company acting as a single entity attempts to monopolize the Mississippi market? The analysis presented by Mr. Frame says that if the Southern Company, the parent and
controlling authority of MPCo, curtails generation in the Mississippi market, the HHI gets very close to the threshold level for presumption of market power.

Mr. Frame reports HHIs of 2409 and 2384 for the market when the Southern Company and Entergy are treated as a whole. Those values of the HHI exceed the threshold used by the FTC and the Justice Department, which is 1800, and they are very close to the target value of 2500 used by the FERC. In addition, Tables 8 and 10 omit a significant amount of power that MPCo has under contract. If this power is included in the total power controlled by the Southern Company available to the Mississippi market, the HHI rises above the threshold value of 2500.

Mr. Frame argues that it is not appropriate to consider the wholesale and industrial power contracts of MPCo in the market concentration analysis shown in Table 2. Possibly this is correct. However, Mr. Frame includes the power sold under these contracts when he uses the Henwood model to simulate the behavioral responses to a hypothetical price increase in the relevant geographical market. In other words, he assumes that generation capacity committed to MPCo through the wholesale market is redeployed to mitigate the exercise of market power by MPCo. That is not possible, though, unless MPCo unilaterally abrogates those contracts.

The market power study prepared by Mr. Henderson excludes the generating capacity controlled by Entergy in neighboring (“first tier to EMI”) states throughout the analysis. That is, non-EMI generating capacity controlled by its parent company is excluded both from the numerators and the denominators of all market share and market concentration calculations. While this assumption properly rules out competition between EMI and its parent company affiliates, Mr. Henderson’s “hub-and-spoke” approach places MPCo outside the boundary of the relevant geographic market (see Exhibits JSH-9A-1, JSH-9B-1, JSH-9C-1, and JSH-9D-1). Given that Mr. Frame concludes that neither MPCo nor EMI could unilaterally raise price profitably by 5 percent and, hence, that the relevant geographic market for generation includes the territories served by both of them, it should not be surprising that Mr. Henderson finds no evidence of market power.

The dispatch simulations of both MPCo and EMI appear to include TVA generation in the set available to mitigate monopoly restriction. While this may be true indirectly, TVA can only sell its power to a specific set of customers, of which Entergy and the Southern Company are two.

ii) New Generation Sources

In spite of the fact that based on the utilities’ own analysis there is some concern about the possibility of market power based on currently installed generation, we generally agree with the conclusion of both studies that the potential for the construction of new generation facilities mitigates the possibly of the exercise of market power in the longer term. Even so, we must be careful in reaching this conclusion.  

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5 According to Mr. Frame (p. 29), approximately 10 percent of MPCo’s load is sold to industrial customers under contracts that extend beyond 2002. Also, 22.5 percent of MPCo’s energy requirements are wholesale contracts.

6 As discussed below, mitigation of market power may, in addition to the construction of new generating capacity, require structural separation of generation and transmission.
It is true that new generation facilities are much cheaper to build and to operate today than they have ever been in the past. Nonetheless, a new generation facility requires a substantial financial investment and a construction lead-time of 1.5 to 2 years after the required permits have been obtained. It is not something that will be done without careful consideration. New generation facilities will be brought online only if the owners feel confident that the power generated by their plants can profitably reach the market.

iii) Implication of the Studies

The conclusion is that there may be a concern about market power based on currently installed generation. Indeed, the PSC Staff’s guidelines for preparing market power studies underscore such concerns by requiring EMI and MPCo to assume that there will be no new entry of generation capacity or construction of any new transmission links unless such projects already have been identified or planned. As a consequence we are primarily appealing to new entrants into the generation market to provide the biting edge of competition. Because of this the question of vertical market power between generation and transmission becomes crucial.

b) Market Power through Vertical Integration of Generation and Transmission

The market power studies of both utilities claim that there is no threat of vertical market power because regulations by the Federal Energy Regulatory Commission (FERC) require the utilities to allow open access to the transmission facilities. While open transmission access is the goal of regulations by the FERC, it is still possible that abuses can occur. At times when there are excessive line loads, the protocols that determine which scheduled transmissions will be canceled are not perfectly well defined. Also, there is the issue of the transmission-owning utility reserving the lion’s share of its transmission capacity in order to meet its native load. To the extent that the utility owning the transmission lines favors its own generation over the generation of competing suppliers it may be able to exercise monopoly power.

Let’s consider a hypothetical example. Suppose that an open access supplier like New Energy Ventures (NEV) attempts to serve Hattiesburg by buying power from South Carolina Electric & Gas. To move this power from South Carolina to Mississippi, NEV must schedule transmission capacity across the Southern Company’s territory. In particular it will cross Georgia Power and Alabama Power before reaching the transmission lines of MPCo. Let’s also assume that transmission of power from a Southern Company generation facility to the MPCo territory is also scheduled. If a line in Alabama reaches its capacity so that either the scheduled transmission for NEV or that of the Southern Company must be dumped, the fear is that it is the transmission for NEV will always be canceled first.

An ongoing dispute between Aquila Power Corporation and Entergy Services, Inc., shows other dimensions of potential abuses of the control of the transmission system. In a complaint by Aquila filed at the FERC, Aquila claims that Entergy denied access to its transmission system, stating that the transmission capacity was necessary to serve Entergy’s native load. In a particular example, Aquila alleges that during an off-peak period Entergy denied the acceptance of a delivery to be made by Aquila to Entergy at the Union Electric-Entergy interface. The sales price of the Aquila power at the Entergy border was $22/MWh. Aquila was forced to sell the
power to another buyer for $7.50/MWh. The power was then resold to Entergy. No doubt, the price that Entergy paid was much lower than $22/MWh. In another situation, Entergy cut a delivery by Aquila intended for the Sam Rayburn G&T Electric Cooperative (an Entergy network customer). Entergy then made up this shortfall from its own generation resources. The shortfall was priced using Entergy’s emergency rate schedule. In yet another case, Entergy denied Aquila Power’s transmission request (Associated Electric to Entergy for Cajun), and then used the same path for its own sale to the same customer. In all of these cases, Entergy was allegedly able to use its control of transmission resources to gain an economic advantage in the generation market. While it may be that these charges are completely unfounded, they do illustrate the kinds of abuses that may result from the joint control of transmission and generation assets.

It is clear that the FERC is concerned with preventing abuses of transmission scheduling. There are provisions built into the regulations that offer relief. For instance, if scheduled transmissions are consistently canceled, the utility can be forced to add transmission capacity to the line. However, remedies such as these are tedious and time consuming. The better solution, and the one the FERC is groping for, is to thwart vertical monopolization by separating the control of generation and transmission.

i) Entergy’s TRANSCO Proposal as a Solution

Entergy has filed a report to the Commission in which the company proposes to separate its transmission system from the rest of the company. Entergy proposes to form a new, wholly owned but completely independent subsidiary that will be in complete control of the transmission facilities currently owned by Entergy. This separate transmission company would hereafter be in charge of planning, constructing, and operating any new transmission resources in the Entergy system territory. The subsidiary would share accounting and similar support resources with the parent, but would otherwise be separate.

Our feeling is that this proposal is a good start toward ensuring that there will be no exercise of vertical market power in the EMI territory in Mississippi. Entergy’s proposal represents a step in the right direction of successfully mitigating market power of vertically integrated utilities on the wholesale side and allowing the benefits of competition to be available to retail providers in Mississippi.

We agree with EMI that separation of the control of transmission and generation is necessary. The question comes down to what form of separation will be adopted. EMI argues strongly against creation of some non-profit entity that would control transmission resources. Indeed, the merits of the profit system are the centerpiece of the logic EMI presents in favor of the proposal. In this regard, our view is to follow the logic used by EMI to its obvious conclusion. We wonder if the transmission resources of EMI should be completely spun off.

EMI wants to form a wholly owned subsidiary under separate managerial control. Having gone this far, why not truly enjoy the benefits of the market and make the transmission entity a separately owned company? One of the benefits of making the transco a separate company is that the financial market will continuously offer a direct assessment of the efficiency of its
operations. That is, the stock price of the independent transco will be a bellwether of the soundness of the judgments and decisions made by the company’s managers. In spinning off the transco, Entergy shareholders will get one share of stock in the transco for every share of Entergy that they hold. Hence, shareholders will be unaffected. Indeed, they will be better off as a result of the spin-off because they will have more portfolio options. They will be able to make individual choices of whether to hold only generation and marketing, only transmission, or both. In fact, the main rationale EMI appeals to as a reason why the transco should not be completely spun off is the shared use of accounting and support resources. However, if the management of the transco as a subsidiary is to be truly separate, firewalls in these support services must be built. To that extent, if the transco is completely spun off, nothing is actually lost. As a completely separate company, the transco can choose to buy accounting and support services from Entergy, which it will do if Entergy is the cheapest supplier. Moreover, if the transco is completely separate and chooses to buy accounting services from Entergy, there is no concern about firewalls.

The bottom line is that we think the Entergy proposal is worth considering because it is directed at solving what seems to us to be the most important issue in market power in generation.

c) Other Remedies

All things considered, if there is no monopoly abuse of the transmission system, we believe that there will be no market power in generation in the operation of a competitive retail electric market in Mississippi. Our conclusion is that the Commission should continue moving toward implementing retail competition.

To this end, the studies by the utilities and other respondents point out issues that the Commission should watch as competition develops. In the event that the Commission sees that market power in generation does exist and is not being mitigated either by inflows of power from outside the service territories of the two utilities or by construction of new generation facilities in Mississippi, the Commission may be required to take more drastic steps. The most obvious way to assure mitigation of market power in generation is to force EMI and MPCo to divest themselves of their generation assets in Mississippi.

4) Market Power in Customer Access

A notable omission in the market power filings by MPCo and EMI is any serious discussion of the effect on consumer wellbeing from market power at the retail level. The entire study by EMI and nearly all of the MPCo study are devoted to the issue of market power at the level of wholesale generation. The studies conclude that there is no serious threat of market power in generation because of ample competition from around country and potential new generation sources. Even so, the reader is left wondering to what extent wholesale market power matters if all the retail customers continue to be served by the incumbent utilities.

In other words, let’s assume that the dispatch model used by the two respondents is correct and that a curtailment of generation by either utility could arguably be made up by energy inflows
from outside the region. Let’s also assume that the control of transmission resources is separated from generation so that available generation can feasibly reach the Mississippi market. But those inflows cannot get to the final customers if all the customers are served by the very utilities that are cutting output and raising price. A fundamental issue that is not addressed by MPCo or EMI is that of market power in retail access.

a) Rebuttable Presumption and Justifiable Concern

The fact that the utilities failed to respond to this question is curious. As is pointed out in the Revised Plan, there is a rebuttable presumption of market power. This means that unless the utilities can convincingly demonstrate otherwise, the Commission will assume that market power exists.

Market power at the level of retail access is just as damaging to consumer wellbeing as market power in generation. Indeed, the retail or final customer is the chief concern of the Commission. So market power at the level of the retail provider may arguably be the most important issue to be addressed in this process.

b) Expectations about Market Shares for the Incumbent Utilities

The question before the Commission is, How concentrated can we expect the retail electricity market to be when competition is allowed? That is, how much of the customer market is the incumbent utility likely to lose when customers are given the right to choose their own Energy Service Provider? To answer this question, it is instructive to reflect on the events that occurred in the breakup of the regulated long-distance telephone market. Those events should give us a good forecast of what is likely to happen to the market shares of competing providers as open access is instituted in the electricity market.

One of the chief concerns in breaking up the old Bell System was to put all long-distance service providers on an equal footing. To that end, the new regional phone companies were ordered by U.S. District Judge Harold Greene to install switching systems so that long-distance telephone customers could subscribe to competing service providers as easily as they could sign up for AT&T.  

Although “equal access” was mandated by Judge Greene, the seven regional Bell operating companies (RBOCs) were individually allowed to determine the process by which long-distance customers could take advantage of the opportunity to switch providers. In all but one of the markets, customers were not required to make an affirmative choice. Instead, after they had been solicited by rival long-distance companies, which deluged them with promotional mailings, phone calls, and in some cases personal visits, customers were then required to contact their long-distance company of choice and arrange service connections. AT&T was the default provider for consumers who failed to select one of the competing long-distance companies and,

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7 Judge Greene issued his order in 1984. Phone companies were told to have the new systems in place by September 1, 1986. Michael Isikoff, “Phone Firms Stumping in West Virginia”, Washington Post, 12 April 1984, p. A1.
not surprisingly, the incumbent AT&T held on to between 85 and 90 percent of its customer base.

Only Northwestern Bell did something different. It set up a balloting procedure, providing customers with lists of alternative service providers and giving them 90 days to respond. If the ballot was not returned, the indecisive customer was contacted a second time by mail and told that he would likely be assigned to a long-distance company, thus giving him another chance to make a selection. Customers who bypassed this second opportunity to pick a long-distance carrier were assigned to service providers randomly, but in proportion to the “votes” the companies received on ballots that had been returned. For example, if AT&T was picked by 70 percent of the customers who affirmatively selected a long-distance carrier, then 70 percent of the indecisive customers were connected to AT&T’s long-distance lines. Between 72 percent and 83 percent of long-distance telephone customers made choices under Northwestern Bell’s balloting procedure, whereas only about 50 percent of them did under the alternative process adopted by the other RBOCs.\textsuperscript{9} Northwestern’s customer-assignment process resulted in AT&T retaining about 75 percent of its customer base.

The sharp disparity in the outcomes produced under the two regimes governing the allocation of customers to rival long-distance telephone companies prompted the Federal Communications Commission to intervene and ultimately to order that all RBOCs use Northwestern Bell’s balloting system. Prior to issuing its order, FCC Chairman Mark Fowler was quoted as saying that “allowing the indecisive customer to go to AT&T by default is ‘neither legal nor proper’” and, indeed, the FCC’s staff considered the possibility that automatic default violated the antitrust laws.\textsuperscript{10} In a decision endorsed by the Justice Department,\textsuperscript{11} the FCC issued a unanimous ruling on May 31, 1985, requiring all of the regional telephone companies to adopt Northwestern Bell’s customer-assignment method.\textsuperscript{12} Under the new system, up to 92 percent of long-distance telephone customers made a choice of carrier,\textsuperscript{13} and, although AT&T still came out on top, it captured 75 percent of the customers, not 90 percent.\textsuperscript{14}

The straightforward conclusion that we can draw from this experience is that the incumbent electric utility can be expected to retain 85 to 90 percent of its customers in the absence of action by the Commission. If nothing is done to encourage customers to make an active choice and if there is no allocation scheme for the customers who do not actively choose an energy provider, the incumbent utilities can be expected to retain a large majority of the customer base. A market share on the order of 85 to 90 percent exceeds the thresholds that that would trigger antitrust concerns and should be considered an undue threat of the exercise of market power.\textsuperscript{15} In other

\textsuperscript{10} Ibid.
\textsuperscript{13} Bruce Keppel, “Long-Distance Phone Firms in Race for Area Customers”, \textit{Los Angeles Times}, 9 June 1986, part 4, p. 1.
\textsuperscript{14} Terry Dodsworth, “Most Callers Now Have a Choice”, \textit{Financial Times} (London), 1 December 1986, p. III.
\textsuperscript{15} It is the equivalent of 7225 on the Herfindahl-Hirschman Index even if the rest of the market is not included in the calculation (the square of 85 percent is 7225). This is substantially larger than 1800, the benchmark for antitrust action, and 2500, the value deemed to be the acceptable upper bound in oil pipeline market. See Appendix A.
words, if EMI and MPCo retain 85 to 90 percent of their customers, this degree of market concentration warrants the presumption that they will be able to exercise market power.\textsuperscript{16}

c) Monitoring Competition

The Commission has the duty to protect consumers and to monitor the electricity industry to ensure that it acts in the public interest. Even though competition in the supply of electric generation is feasible, there is the possibility that there will be market power in access to consumers. Hence, even though there may be no market power in generation, consumers will face prices that are above competitive levels.

In the event that market power is a concern, the Revised Plan calls for the Commission to monitor the competitive market. We think that monitoring is absolutely essential in the public interest and is the duty of the Commission in all events.

The competitive transition plan formulated by the Commission Staff and revised by the Commission already anticipates that some action may be required by the Commission to monitor and protect the competitive market. The plan calls for the existing utilities to set rate tariffs at the outset of competition that represent the price that default customers will pay. Default customers are those who do not make an active choice of energy service provider (ESP). This set of tariffs is called the Transition Standard Offer (TSO).

We propose that the Commission adopt a plan for a “Standard Offer” that continues the idea of a TSO into the foreseeable future.

i) Relevant Geographic Markets

In the market power study of MPCo, the relevant geographic market is considered to be the existing service territories of the two investor-owned utilities combined; in the Entergy market power study, the geographic market is EMI’s existing territory alone. The issue addressed in this section is the relevant geographic market for retail customer access, which we think is different from the market that is relevant for generation.

Whatever market power the utilities may have in customer access comes from their name recognition. MPCo has little more customer appeal in EMI’s territory than would Enron, Cenergy, or New Energy Ventures. Hence, we think that that there are two relevant geographical markets for retail electricity customers, namely the existing individual service territories of the two utilities.

\textsuperscript{16} As Mr. Frame (p. 24) notes, the Justice Department’s \textit{Merger Guidelines} “uses a single firm share of 35 percent as a screening threshold to denote situations where the exercise of market power on a unilateral basis potentially might be a concern.”
ii) Initiating Competition

In the competitive retail electric market there are two types of customers: default customers and customers who have made an active choice of energy supplier. As we move from regulation to competition, all customers are default; they start out as customers of the two existing utilities. Competitive ESPs will solicit customers. These ESPs will include new companies that enter the Mississippi market as well as the competitive affiliates of EMI and MPCo. As discussed above, our expectation is that a large majority of customers will remain with EMI and MPCo either because they fail to make an active choice or because they affirmatively choose to sign up with the competitive ESP affiliate of these two companies.

The Revised Plan calls for a pre-competition customer sign-up period of six months’ duration, following which ESPs begin to supply the customers that have responded to their solicitations. In the beginning, default customers will be assigned to the ESPs affiliated with the incumbent utilities. However, default customers should be designated as such, and an accurate accounting of these customers should be made.

At the end of the first six months of competitive supply (twelve months after customer solicitation begins), the Commission should monitor the state of the competitive market. This review should assess the market shares of ESPs operating in each of the two service territories. The market share of the incumbent utility should be assessed by summing its default customers with the consumers who have actively signed up with its competitive ESP affiliate.

(1) Trigger points and threshold values

If the market share of the incumbent utility is greater than 75 percent, or if the HHI is greater than 5800, then the Commission should take action to prevent the exercise of market power. We recognize that these trigger points are much larger than the ones used by the antitrust authorities as threshold values for the presumed existence of market power. Even so, they represent an appreciation of the feelings of many that the evolution of competition in the electric industry should not be overly intrusive.

If the trigger points are exceeded after the first six months, the Commission should conduct another assessment of market shares three months later. If the trigger points are still exceeded, the Commission should set in motion a process of mitigating the exercise of market power.

(2) Mitigating Market Power By Bidding Off Default Customers

Default customers are and always will be an important component of the customer base in the electric industry just as they are in telecommunications. Moreover, the default customers are the ones with whom the Commission should be most justifiably concerned. Default customers are consumers who for various reasons have not made an active choice of electricity supplier. It is quite possible that these consumers have failed to act simply because they assume that they are protected by the oversight of the Commission. Hence, allocation of default customers is a way for the Commission to ensure competitive prices in the industry and to fulfill its mandate of protecting the public interest.
Our proposal is that if the trigger values of market concentration are exceeded, the Commission should solicit bids for a “Standard Offer.” This Standard Offer will perform the same function as the Transition Standard Offer. It will represent the rates charged to default customers.\textsuperscript{17}

In the event of the presumption of market power, Standard Offer bids will be solicited from suppliers other than the incumbent utilities. The competitive Standard Offer bids will be compared to the TSO of the incumbent utilities.

The competitive Standard Offer bids will be for all default customers in the relevant geographical markets, which are the existing service territories of EMI and MPCo. Competitive bidding may be required in only one of the two territories. However, if competitive bidding is required in a service territory, it will be for all default customers in that territory. This Standard Offer is a bid for the default customers of the incumbent utility, not for the customers who have actively signed up with its competitive ESP affiliate.

In assessing the competitive Standard Offers, the Commission should use its discretion. It should not be the case that the Commission is required to accept a competitive Standard Offer simply because it is lower than the TSO of the incumbent utility. The Commission must consider things like the viability of the offer. However, if the Commission is convinced that a competitive Standard Offer is legitimate, viable, and significantly more attractive than the TSO, the Commission should supplant the incumbent in favor of the new provider for default customers.

iii) Down the Road in the Competitive Market

Regardless of the \textit{a priori} expectations of market power before competition is initiated and regardless of the findings after the first-period review, the Commission should continue to monitor competition into the foreseeable future. It is inappropriate for the Commission to abrogate its responsibility to oversee the electric industry. The Commission has the charge to make sure that the industry operates in the public interest. Competitive supply of electric generation appears now to be in the public interest. Moreover, open-access marketing of electric generation supplies appears feasible and in the public interest. However, it is the mandate of the Commission to continue to review performance and to take steps to ensure that the electric industry operates in the public interest.

We believe that every six months, the Commission should assess the market shares of ESPs operating in the two service territories. In the event that the trigger points identified above (i.e., a market share of the dominant firm greater than 75 percent or an HHI larger than 5800) are exceeded, the Commission should begin the mitigation process. This process involves reassessment of market shares three months later and then competitive bidding of default customers after that, if necessary.

Also, we think that the Commission should engage in a periodic review of the TSO, which in our opinion should become an ongoing Standard Offer for default customers. This review need only be done every two years or so. It should assess the outstanding TSO/SO in light of the

\textsuperscript{17} There is an issue of what rates can be charged by the ESP acting as the default supplier. We address this shortly.
competitive market prices offered by ESPs. If the TSO/SO is significantly out of line, competitive bidding should occur.

It is important to recognize that the mitigation process that we have proposed is directed at default customers only. While it is possible that default customers will make up only a small fraction of the total customer base, we feel that they are an important margin of competition and the appropriate focus of monitoring and action by the Commission. First, there will always be default customers. Every time someone moves, that person potentially becomes a default customer. Moreover, every consumer has the right to elect to be a default customer. If a consumer has signed up with a new ESP and decides to change, all the consumer has to do is cancel service with that ESP. At that point, the consumer becomes a default customer. The default portion of the customer base will always be significant, even if does not represent a majority of all customers.

Second, if the default portion of the customer base is small, then consumers have spoken. Whichever company they have actively chosen, it is their decision. Who is to say that the Commission should second-guess this choice? In the beginning, it may be appropriate for the Commission to send an information sheet to electricity consumers explaining their options in the new, competitive electric market. This information sheet can explain that if customers do not make an active choice of energy service provider, they will be designated as a default customer and served by the provider designated as such by the Commission. In the beginning, this default provider is the incumbent utility. However, this may change if the Commission feels it is in the best interest of consumers.

iv) Other Issues

Whichever ESP acts as the default provider, it must keep track of which customers are default customers and which of its customers have actively chosen it as their service provider. When customer solicitation begins, all customers are default customers and assigned as such to the ESPs affiliated with the incumbent utilities. The affiliated ESPs will begin soliciting these customers, as will new competitors. Competitors should be allowed access to the database of default customers.

In the beginning the TSO is the price offered to all customers. If they actively choose an ESP, then they will pay the rates offered in that contract. If, after some point, the Commission chooses a new default provider, its Standard Offer represents the rates charged to default customers. The ESP acting as the default provider may charge rates that are different from its Standard Offer. Competition will not likely allow it to charge rates higher than the Standard Offer, but it should be allowed to charge lower rates if it so chooses so long as these different rates reflect different types of service. In particular, in the beginning, the incumbent utilities should not be allowed to charge rates lower than their TSO for identical service.

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18 Which is the Transition Standard Offer in the beginning.
5) Conclusions

While this report has pointed out some concerns with respect to the question of market power in a competitive electric industry, our conclusion is that the Commission should proceed to implement retail competition in the Mississippi electric industry. None of the questions and concerns that we have raised is sufficient either separately or in total to forestall the process. Competition will work in the electric industry just as it works in every other line of commerce and industry. It may move by fits and starts. Even so, competitive barriers will be worn away, and consumers will ultimately be served in the fashion that they most desire and at a price that approximates the true cost of service.

The main issues addressed in this report and in the process of implementing competition involve identifying the things the Commission needs to do to create an atmosphere most conducive to the free functioning of the competitive market. On the questions of market power, our main conclusions are:

- First, the commission needs to keep a watchful eye on abuses of market power in generation supplies by vertical control of the transmission system.

- Second, market shares in customer access should be monitored frequently. If excessive market concentration occurs, the Commission can protect consumer interests by bidding off the default provider rights.

On the first point, the Commission is in the process of reviewing a proposal by Entergy for the creation of a separate transmission subsidiary. We think that this proposal will help mitigate abuses of vertical market power and that the Commission should look favorably on this proposal. Similar steps should be encouraged in the Southern Company’s territory. While regulation of the transmission system has been claimed as the prerogative of the FERC, abuses of market power through the vertical integration of transmission and generation have heightened importance in a competitive retail electric market in Mississippi. Hence, the Commission must monitor the market carefully and take whatever steps are necessary to ensure that there is no exercise of market power in the supply of generation.

On the second point, we think that, as a result of customer inertia, it is very likely that the incumbent utilities will retain a large portion of their existing customer base by default when the retail competition is allowed and the largest portion of these will be residential customers. As proponents of competition, we strongly support customer choice. If all of the customers in the MPCo service territory actively choose to be served by MPCo, then that is the way it should be. On the other hand, the Commission has the responsibility of protecting consumers, in particular those consumers who because of a lack of information have not made an active choice of ESP. On this point, we think that the Commission can fulfill its responsibility by monitoring market concentration among ESPs, and should the market concentration be so large as to threaten abuses of market power, an adequate remedy is auctioning off the default customers to the provider that offers the most attractive rates. The Commission should also inform consumers that if they do not wish to make an active choice, they will be assigned to the default provider chosen by the Commission and pay rates that are monitored by the Commission.
In the end, our most firmly held belief is that the Commission will have to do nothing in a competitive electric market except sit back and watch. However, it may well be that the watchful eye of the Commission is the most important element of the structure of a well functioning competitive retail electric market.