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FERC Considering Changes to Standards of Review for Acquisitions and Mergers

By Wilbur C. Earley*

This article explains a recent Federal Energy Regulatory Commission Notice of Inquiry that could result in significant changes to the standards used for analyzing whether mergers and acquisitions are in the public interest.

The Federal Energy Regulatory Commission ("FERC") recently launched an initiative that could result in significant changes to the standards used for analyzing whether mergers and acquisitions are in the public interest. In a recent Notice of Inquiry[1] ("NOI"), FERC identified several broad areas in which its current policies may need reform, made a few suggestions and asked for public comment. Depending on the comments received, a formal rulemaking initiative could result.

Given the significant volume of acquisitions of securities and facilities in the electricity industry that require FERC review, this NOI may mark the first step in policy changes that would affect a wide range of industry participants.

Section 203 of the Federal Power Act ("FPA") requires FERC to approve a transaction (*i.e.,* a disposition, acquisition or consolidation of jurisdictional facilities) if it is "consistent with the public interest." One of the public interest factors FERC examines is the transaction's impact on competition in electricity markets. The NOI focuses on the impact on horizontal competition (the consolidation of generation resources). Under current policies, an applicant may show that a transaction will not have an adverse impact on competition by: (1) explaining how the transaction does not result in any increase in the amount of generation capacity owned or controlled collectively by the applicant; (2) explaining how the transaction results in a *de minimis* change in its market power; or (3) submitting a Competitive Analysis Screen, which determines the scope of the relevant geographic market by identifying potential suppliers and determines the effects of a transaction on concentration. FERC relies on a numerical index, the Herfindahl-Hirschman Index, or HHI, to measure the

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[1] http://www.ferc.gov/whats-new/comm-meet/2016/092216/E-2.pdf.

concentration of generation capacity in a market.[2] In the absence of countervailing evidence, FERC will find a transaction has an adverse impact on competition if the transaction increases the HHI by more than 100 points in a moderately concentrated market (where the HHI ranges from 1000 to 1800) or more than 50 points in a highly concentrated market (where the HHI exceeds 1800).[3]

Following is a brief discussion of the major topics of FERC's competitive analysis on which it sought comment.

THE *DE MINIMIS* SHOWING

As stated earlier, applicants may avoid submitting a Competitive Analysis Screen by showing that a transaction's impact on competition is *de minimis*. However, FERC has neither defined *de minimis* nor identified a threshold, and has accepted various representations made by applicants. For example, applicants have claimed a transaction's effect on horizontal competition is *de minimis* because the combined share of post-transaction capacity will be relatively small, while others have argued that the post-transaction market share will be large but the HHI increase is small. FERC sought comment on whether it should establish a specific threshold for measuring whether a transaction's impact is *de minimis* and, if so, how that threshold should be calculated.

FERC is also concerned about using the *de minimis* standard for serial mergers in which an applicant with a large market share incrementally acquires additional capacity such that each proposed transaction individually would not require a Competitive Analysis Screen, but taken as a whole the transactions would require a more in depth examination. FERC wants to know if serial mergers should be part of its competition analysis. FERC suggested a threshold of mergers resulting in a cumulative market share increase of 10 percent or more over five years.

SUPPLY CURVE ANALYSIS

A supply curve analysis uses demand and supply curves to assess whether a merged company has the ability and incentive to exercise market power by withholding output from marginal generating units to raise prices in order to benefit its baseload units and thereby increase its total profits. The ability to withhold output depends on the amount of marginal capacity that would be

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[2] The HHI is the sum of the squares of the market shares of each seller in a market. The Department of Justice's Horizontal Merger Guidelines use the HHI as an indicator of market concentration.

[3] For context, the HHI of a perfect monopoly market is 10,000 and that of a market with five sellers each with a 20 percent market is 2000.

controlled by the merged firm, and the incentive to withhold output depends on the amount of inframarginal capacity that could benefit from higher prices. The Competitive Analysis Screen examines only aggregate capacity in the relevant market, not the structure of that capacity, and thus does not measure the incentive and ability to withhold generation capacity from the market.

FERC sought comments on whether a supply curve analysis should be required as part of the Competitive Analysis Screen.

ADDING NEW METRICS: "PIVOTAL SUPPLIER" AND "MARKET SHARE"

In the non-merger context, FERC assesses market power in evaluating requests by sellers to charge market-based rates for sales of generation services instead of cost-based rates. In this context, FERC examines the unilateral ability of the seller to exercise market power and raise prices. In the merger context, however, FERC generally examines the impact of a transaction on overall concentration in a market. In the NOI, FERC sought comment on whether it should incorporate in its merger analysis the two primary metrics used in its market-based rate analysis: pivotal supplier and market share.

Pivotal Supplier

A supplier is pivotal if any of its uncommitted generation capacity is needed to serve any of the wholesale load in a market; if so, the supplier may be regarded as having market power. According to FERC, adding a pivotal supplier test could make its FPA Section 203 analysis more effective by taking into account the ability to meet demand, in addition to considering supply conditions, in screening for market power. In more concentrated markets, a pivotal supplier analysis provides important information about the ability to exercise market power because small changes in supply could lead to large changes in price. The analysis could also show whether demand is low enough compared to existing supply such that a large HHI change does not necessarily create the ability to withhold output because competing suppliers can adequately serve load.

FERC also requested comments on whether the current pivotal supplier analysis applied in market-based rate cases works effectively for purposes of analyzing market power in that context.

Market Share

Market share measures the share a seller's uncommitted generation capacity has of the total amount of uncommitted capacity in the market. In other words, market share measures whether a seller has a dominant position in the market. In the market-based rate context, FERC generally regards a seller with a market

share of 20 percent or less as not having market power. Among other things, FERC sought comment on whether a market share threshold is appropriate in its review of merger and acquisition applications, and whether a market share threshold, or an alternative analysis, would adequately address concerns that an entity has accumulated a dominant position in a market over time through a series of acquisitions (*i.e.*, the serial merger theory).

CONTROL OF RESOURCES THROUGH PURCHASED POWER AGREEMENTS

For analytic purposes, FERC attributes control of generation capacity committed in a long-term power purchase agreement ("PPA") to the purchasing utility. Thus, if a purchasing utility proposes to acquire the generation facility providing the power in the PPA, the capacity of that facility is attributed to the purchasing utility's pre-acquisition market share, meaning the acquisition will not increase the purchaser's market share or the market HHI. But when the PPA expires, the transaction may prevent this competitive supply from reentering the market. To increase the accuracy of its market power analyses, FERC requested comments on whether it should use alternative methodologies in its review of a Section 203 application to account for the capacity committed in long-term firm PPAs.

REQUIRING ADDITIONAL MERGER-RELATED DOCUMENTS

The NOI explains that applicants now must submit to the Department of Justice ("DOJ") or the Federal Trade Commission ("FTC") consultant reports and other internal reports that assess the competitive effects of a merger. FERC believes these merger-related documents could be useful in understanding an applicant's competitive analysis by providing additional information regarding, for example, the relevant geographic market definition or anticipated unit retirements. In the NOI, FERC has asked whether it should require applicants to submit, as part of their Section 203 applications, these reports required by DOJ and/or FTC.

RECONSIDERING BLANKET AUTHORIZATIONS

FERC's regulations grant blanket authorizations for certain types of transactions. Under these blanket authorizations, even though the transaction may be jurisdictional under Section 203, no application or FERC authorization is needed prior to completing the transaction. The NOI notes that since the time these blanket authorizations were granted, the industry has undergone substantial change, and the blanket authorizations may no longer be appropriate. For example, it may no longer be appropriate to grant blanket authorizations to holding companies that only hold exempt wholesale generators because exempt wholesale generators now make up a significant portion of supply, and any

transaction involving these generators could affect wholesale rates by impacting competition. Accordingly, FERC sought comment on whether there are existing blanket authorizations under Section 203 that are no longer appropriate.

ABBREVIATED FILING REQUIREMENTS FOR CERTAIN TRANSACTIONS

For certain types of transactions, Section 203 establishes a minimum threshold of $10 million for requiring FERC approval. In contrast, there is no minimum dollar threshold in Section 203(a)(1)(B), which requires a public utility to get prior FERC authorization before it "merge[s] or consolidate[s], directly or indirectly" its jurisdictional facilities with those of another person. According to the NOI, this means transfers of low-value equipment require FERC review. FERC sought comment on whether there are categories of proposed transactions jurisdictional only under Section 203(a)(1)(B) that do not require the same level of FERC scrutiny required for more significant transactions. The NOI notes that one such category could include transactions below a specified minimum dollar threshold.