

Coalition for Fair Competition in Rural Markets

Re: **V010003 -- Comments Regarding Retail Electricity Competition**

Federal Trade Commission

Submitted by Patton Boggs LLP

Counsel to the Coalition for Fair Competition in Rural Markets

On behalf of The Coalition for Fair Competition in Rural Markets (the “Coalition”), an organization comprised of private companies in the retail propane industry and of national and state propane trade associations, we appreciate the opportunity to submit these comments as the Commission considers the implications of restructuring the electric utility industry. As certain government-subsidized players in a potentially restructured utility industry cast about for ways to enhance their profitability, their initiatives—if unchecked by principles of fairness—may have a destructive impact on consumers and on longstanding and otherwise robustly competitive private industries. We believe the FTC will want to be mindful of these potentially devastating collateral consequences of unleashing players with government-conferred market power into private markets—and thus respectfully submit these Comments addressing primarily the “Consumer Protection Issues” identified by the Commission in its Notice.

The utility players consist primarily of investor-owned utilities, municipal utilities, and rural electric cooperatives (“RECs”). The Coalition’s concern is with the leveraging power of the latter—who often seek exemptions from some of the competitive dimensions of restructuring, yet wish to retain the power to leverage their government-conferred monopoly power into private markets such as the propane industry.

RECs were established for the sole purpose of generating and providing electricity to rural areas of the nation—and the Coalition salutes their achievement in the substantially complete electrification of rural America. However, RECs are now exploiting their special status as federally subsidized, tax exempt organizations to enter retail propane gas distribution and other lines of business wholly unrelated to electricity. Thus do RECs leverage the tremendous economic advantages that they alone enjoy as federally subsidized, tax-exempt businesses to compete against private sector, mostly small, businesses which do not enjoy the same federal benefits. No business, small or large, can survive in the long-run competing against federally-subsidized, tax exempt operations.

If RECs are permitted to enter new lines of business, the Commission or other regulating entities should require that such entry be on exactly the same basis as any private sector competitor—in other words, that RECs enter on a “level playing field”—without the benefit of federal subsidies and tax exempt status. This issue is the top priority of the nation’s propane industry.

The issue outlined above has been an integral part of the debate in Congress, as it has considered legislation to address restructuring the electric utility industry, and has also been integral to the debate over restructuring the industry in several important states. Certain states, such as Virginia, have fairly addressed the issue of competition from subsidized RECs in competitive industries. The following comments briefly describe the competitive issues in play when a subsidized REC enters a competitive marketplace; what defines a level playing field, how entry

into a competitive market by a subsidized REC affects, negatively or positively, “rural economic development,” how cross-subsidization distorts the free market, and what legal and legislative precedents exist on these issues.

The Importance of a “Level Playing Field”

A truly “level playing field” means the same rules for all market players—no special privileges for one set of competitors. A level playing field does not mean that every company must be identical. Propane distribution is predominantly a small-business enterprise, but the 8,000 propane companies across America come in all shapes and sizes, and bring different talents to the market. One company may be managed better; another company may have better customer relations; and another may negotiate better supply arrangements. These differences define the competitive process at the heart of our free enterprise system. But no matter how talented or popular these 8,000 propane companies may be, they cannot compete on a level field with utilities who get:

- exemption from substantial income taxes;
- access to favorable financing and loan guarantees;
- substantial good will and popular name and logo recognition as the provider of electricity;
- territorial monopolies for their primary electricity business; and
- substantial marketing advantages from valuable customer lists and research information.

A 1989 study commissioned by the Small Business Administration noted that RECS “enjoy considerable advantages over their small business competitors in terms of the financing of their endeavors,” and referenced below-market rate financing through RUS’ predecessor. The study further observed that while “99 percent of America’s farms are receiving electricity,” RECs “still have access to these below market rates.” The same SBA study noted that in addition to advantageous government financing, “cooperatives can borrow money at rates lower than any small business competitors could hope to have made available to them because of the loan guarantee program of the National Rural Utilities Cooperative Finance Corporation.”

When private companies cannot repay their loans, they suffer the consequences. Here again have RECs enjoyed privileges unavailable to propane companies. In the late 1990s, RECs demanded and received \$1.5 billion in loan write-downs after threatening bankruptcy. Unfair REC privileges do not stop at sources of capital and financing. As the SBA study observed, “when a utility establishes a subsidiary which offers products to area consumers, the subsidiary starts out with marketing advantages which no new independent enterprise would have.” These include:

- customer research information
- name and logo recognition
- energy audit information

Consumers benefit through lower prices and better product and service innovations when fair competition allows the most efficient companies to win customers—*not* when government-conferred monopolists crowd out traditional private markets.

- There cannot be truly fair competition without a level playing field.
- Healthy and rigorous competition has been a fixture of private propane markets for many decades. Propane companies welcome competition—but object to competitors who use their government-conferred tax and financing privileges to compete against companies that do not enjoy these advantages.

Ultimately, REC invasion of private propane markets causes:

- elimination of competition, as private companies, no matter how efficiently run, cannot compete against government-subsidized monopolists; and/or
- diminished demand for propane as RECs succeed in their goal of converting propane customers over to captive electricity customers.

Significantly, rural electric cooperatives themselves demand a “level playing field”—vis-à-vis their utility competitors. When NRECA CEO Glenn English testified before the Energy and Power Subcommittee of the Commerce Committee on October 6, 1999, he outlined four tenets applicable to restructuring the electricity industry, one of which was putting “electric cooperatives on a **level playing field** with respect to the sale of non-electric products or services.” And again, when Mr. English testified in April 2000 concerning the restructuring debate, he decried “different limitations” on utilities’ “ability to participate in the market for non-electric products and services,” and insisted that these “differences are **unbalancing the playing field** in the electric energy market and increasing costs for consumers.” The Coalition vigorously applauds that principle—and invites its precise application to the plight of small propane businesses forced to compete against the government-conferred market power of RECs.

In sum, as expressed in testimony before the U.S. Senate’s Committee on Small Business by Counsel for the Small Business Administration, “the sole result of improper allocation is that small business competitors may be forced out of markets.” Propane companies do not object to any privileges conferred on RECs for the laudable purpose of providing electricity in rural areas. But precisely the indispensable role of RECs in rural electrification makes them fundamentally unfair competitors in private markets.

RECs and Rural Economic Development

It has been suggested that allowing RECs or their subsidiaries to sell propane without restrictions adds “competition” to the propane market, thus reducing prices and benefiting consumers, and generally contributing to “rural economic development.” Unfortunately for rural America, however, RECs invading private and already-competitive markets contribute nothing to genuine rural economic development.

Genuine rural economic development means expanding the economic base and adding real and enduring economic vitality to rural areas. Meaningful economic development entails investment in rural infrastructure and *new* enterprises that diversify otherwise stagnant rural economies. At a 1998 hearing on electric industry deregulation in rural areas, North Carolina representative Eva Clayton had this to say about real rural economic development:

It is important to recognize that the long-term economic health of rural America depends on a broad and diverse economic base which requires investment in rural businesses, infrastructure, housing stock and community facilities.

Rural Utilities Service regulations encourage its borrowers (such as RECs) to consider investing in financially sound projects that are likely to have a positive effect on economic development and employment in rural areas. But if RECs, through subsidiaries or otherwise, simply replace existing private propane sales—and ultimately the companies themselves—there can be no net “positive effect” on economic development or employment. *See* 7 C.F.R. § 1717.858.

If an investment ultimately diminishes competition—or increases monopoly power—then it can hardly be viewed as “rural economic development.” REC investment in propane distribution simply shifts private propane jobs to REC propane jobs and private propane sales to REC propane sales. At best, it constitutes rural economic substitution—not “development”—with a net negative. Indeed, many RECs view their propane subsidiaries primarily as vehicles for capturing captive electricity customers—such that the rural economy becomes even less diversified and more dependent on a single behemoth entity.

In Texas, a former general manager of an REC’s propane subsidiary has confirmed such unfair competition and net-negative rural economic impact in sworn testimony:

- According to the man who served as president of both the cooperative and the propane subsidiary, “the company’s primary goal was to provide a contact point for potential electric customers for Hilco Electric.”
- “Several enterprises were undertaken in order to transfer funds from the Electric Cooperative to the propane business.”
- “The electric meter readers employed by Hilco Electric were routinely instructed to gather information on potential propane customers and pass that information on to Hilco United Services.”
- “Mailings soliciting propane business from potential customers were based on customer lists provided by Hilco Electric.”

Displacing propane businesses—many of which have been small family businesses for decades—disserves rural America and squanders REC potential for good.

Cross Subsidization and How It Distorts the Free Market

Electric cooperatives can cross-subsidize their non-electric business affiliates by providing customer lists, truck fleets, office facilities and equipment, advertising good will, billing inserts, common employees, other shared assets, and suspect marketing arrangements. Thus do REC’s propane affiliates enjoy fundamentally unfair competitive advantages in both capitalization and operations.

For example, sharing intangible assets, such as customer lists and logos, should entail arms-length negotiated transactions—just as private propane distributors must do to develop their

assets. The Internal Revenue Service and the Securities and Exchange Commission require the evaluation of “good will” in commercial transactions. So too do propane businesses derive enormous value from customer lists and good names.

This Commission has testified before numerous state public utility commissions, and addressed the problems associated with cross-subsidization and cost-shifting. For example, in Louisiana, the Commission noted that:

The anticompetitive results may include (1) higher-than-necessary average operating ... costs for the industry and higher prices for consumers due to the continued operation of the affiliate, which can survive with higher-than-necessary costs due to the cross-subsidization; (2) greater market concentration and less competition than would occur absent the cross-subsidization; and (3) discouragement of potential entry that likely would have occurred absent the cross-subsidization, including entry involving innovative products and production processes.

Comments of the Staff of the Bureau of Economics of the Federal Trade Commission, Before the Louisiana Public Service Commission Baton Rouge, Docket Number U-21453 (October 30, 1998).

The Department of Energy issued a report in 1993 which noted some of the problems associated with cross-subsidization and small business competitors:

A regulated firm’s advantage in unregulated markets might arise, not from economies of scale or scope, but from evading regulation. By evading regulation, utilities could compete with independent firms by cross-subsidizing their unregulated service. Two means of evading regulation (and disadvantaging ratepayers) are self-dealing and cost shifting. A utility could use self-dealing and cost shifting strategies if:

- 1) its rates are based on costs, and
- 2) its expenditures cannot be monitored adequately.

The Report then concludes that **“eliminating unfair competition may require preventing cost shifting and self-dealing.”**

In testimony before Congress, however, NRECA CEO Glenn English emphatically denies that RECs cross-subsidize or shift costs:

Let me put that notion to rest right here and now. Electric cooperatives may not, by law, cross-subsidize a subsidiary organization ... All costs of subsidiaries are allocated to these subsidiaries or those subsidiaries are operated with separate staffs and facilities.

Significantly, however—and conspicuously unlike the precedent in other analogous industries (*see infra*)—**no statute or regulation specifically prohibits REC cross-subsidization and cost**

shifting. Nor does the official NRECA position square with the reality in the field. Moreover, mere operation with “separate staffs and facilities” fails entirely to address the significant opportunities for cross-subsidization at the **capitalization** stage of a new propane venture. If an REC’s propane affiliate was capitalized with surplus earnings generated in a tax-free, government-subsidized environment—or with RUS or other government loans, or facilitated by REC loan guarantees—then unfair cross-subsidization has occurred. These observations expose the inevitability of cross-subsidization *and* the great difficulty of detecting and proving it.

Legal and Legislative Precedent

Congress recognized the need to enact stringent affiliate safeguards in the Telecommunications Act of 1996 to prevent the opportunity for market power abuses by the Bell operating companies. These provisions include separate affiliate requirements, biennial audits, restrictions on joint marketing, and prohibitions on preferential treatment.

Section 274, for example, establishes restrictions on the use of name and trade marks by Bell Operating Company (BOC) affiliates when they compete in the electronic publishing business. In addition to requiring a separate subsidiary, this section requires maintenance of separate books, records and accounts. Affiliates are also prohibited from using the BOC’s name or trademark under specified circumstances and prohibited from incurring debt in a manner in which recourse may be had to the BOC. The section further requires proper valuation of assets transferred from the BOC to affiliates to prevent cross-subsidization. The BOC is also prohibited from performing several activities on behalf of its affiliate, including hiring or training personnel, providing equipment, or engaging in research and development.

As one federal court stated, “we find that § 274 has the earmarks of a rather conventional response to commonly perceived risks of anticompetitive behavior. We have long recognized that structural separation is ‘a permissible regulatory tool’ for ensuring ‘that no cross-subsidization or unfair competitive practices occur.’” *BellSouth Corp. v. F.C.C.*, 144 F.3d 58, 65-66 (D.C. Cir. 1998) (quoting *Computer and Communications Industry Ass’n v. FCC*, 693 F.2d 198, 219 (D.C. Cir. 1982)). While the telecommunications industry is the most recent, visible example of decisive federal action to halt the anticompetitive abuses of cross-subsidization, the essential protective principle is a common one. For example:

- The Postal Service—another government-conferred monopoly—is legally restricted in private markets where it faces competition. *See National Ass’n of Greeting Card Publishers v. U.S. Postal Service*, 462 U.S. 810, 829 n.24 (1983) (“Congress’ concern about such cross-subsidies, of course, was one motive for including the rate floor established in § 3622(b)(3).”).
- Medicare providers—as beneficiaries of government largesse—are also statutorily prohibited from cross-subsidizing and shifting costs between covered medical services and uncovered medical services. *See* 42 U.S.C. § 1395x(v)(1)(A).

Yet, cross-subsidization is exceedingly difficult to detect and prove. State laws and regulatory agencies are often ill-equipped to prevent such anticompetitive abuses. As one state regulator observed, cross-subsidization is “very, very, very difficult to prove and to monitor. Something that I’m not sure our commissions have either the skill sets or the manpower to deal with and something that going forward we hope that other agencies will begin to take a look at.” Cross-subsidization, and related anticompetitive abuses, will not go away without an unequivocal prohibition and some means of regular auditing and monitoring. Otherwise, fair competition and diverse rural economies will be casualties.

Commonwealth of Virginia Electricity Restructuring Statute

In response to the Commission seeking comment on features of state electricity restructuring efforts that have benefited consumers, the Coalition respectfully directs the Commission to the electricity restructuring statute in Virginia. Virginia enacted electricity restructuring in 1999, amended the same law in 2000, and the law is slated to go into effect this year. While it is beyond the scope of the Coalition’s interest to provide comments on overall restructuring efforts in Virginia, we wish to draw the Commission’s attention to specific parts of the law which address the issue of REC expansion into non-electricity lines of business and the protections lawmakers provided small businesses in allowing this expansion.

Virginia law, as amended in 2000 by H.B. 797, established new rules and mechanisms for regulating entry into unregulated markets by an REC’s affiliate. These rules include strict guidelines separating regulated utility (electricity) businesses from unregulated businesses and language requiring that RECs enter new lines of business through a legally separate, for-profit affiliate. To ensure fair competition the legislation further requires that rules be promulgated by the State Corporation Commission to:

- Prohibit cost shifting or cross subsidies between a cooperative and its affiliates;
- Prohibit anti-competitive behavior or self-dealing between a cooperative and its affiliates;
- Prohibit a cooperative from engaging in discriminatory behavior towards non-affiliated entities; and
- Establish a code of conduct detailing permissible relations between a cooperative and its affiliates. In promulgating these rules the State Corporation Commission shall consider, among other things whether and, if so under what circumstances, (i) a cooperative may provide its affiliates with customer lists or other customer information, sales leads, joint promotions, etc. unless such information is made available to third parties, (ii) the cooperative’s name, logo or trademark may be used in promotions conducted by its affiliates, and (iii) the cooperative’s vehicles, equipment, office space, and employees may be used by the affiliate.

The Coalition commends this type of legislation as a constructive step toward leveling the playing field between RECs who engage in unregulated businesses and the small, tax-paying businesses with whom they compete.

Requested Action

On behalf of the nearly 8,000 propane companies nationwide, the Coalition requests that the Federal Trade Commission take action to address the concerns raised herein, and specifically to investigate fundamental unfairness where a government-subsidized rural electric cooperative expands beyond its core mission of the generation and distribution of electricity and threatens irreparable harm on existing small businesses in the propane industry. The Coalition believes that the FTC has the appropriate authority, through its ample powers under sections 45 and 46 of the Federal Trade Commission Act, to regulate a prohibition on the practice of cross subsidization and other anticompetitive abuses with respect to RECs who engage in the provision of non-electric related products and services.

Respectfully submitted,

Ed Newberry
Kendrick Macdowell
Brian Lopina
Mike Hettinger
PATTON BOGGS LLP

On behalf of
The Coalition for Fair Competition in Rural
Markets