UNITED STATES OF AMERICA
FEDERAL TRADE COMMISSION
WASHINGTON, D.C. 20580

Before the United States of America Federal Energy Regulatory Commission

Standards of Conduct for Transmission Providers

Docket RM01-10-000

Comment of the Staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission(2)

December 20, 2001

I. Introduction and Summary

The staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission (FTC) appreciates this opportunity to present its views concerning the Federal Energy Regulatory Commission's (FERC) proposed new standards of conduct for natural gas pipelines and transmitting public utilities (jointly referred to as transmission providers).(3) Under the proposal, a single set of standards of conduct would govern the relationship between regulated transmission providers and their energy affiliates, which are often unregulated. We support this proposal to provide comparable regulatory treatment of an affiliate's use of the natural monopoly facilities and assets of the regulated transmission provider because it is likely to assist the development of robust electric power and natural gas markets.

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. In this industry, the staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy in addition to its review of proposed mergers involving electric and gas utility companies. In the course of this work, as well as in antitrust research, investigation, and litigation, the staff applies established principles and recent developments in economic theory and empirical analysis to competition issues. The Commission has issued two Staff Reports (July 2000 and September 2001) on electric power market restructuring issues at the wholesale and retail levels. The July 2000 FTC Staff Report established a policy framework for increased competition in wholesale and retail electric power markets.(4) The September 2001 FTC Staff Report reviewed those features of state retail competition plans that have provided benefits to consumers and those that have not. It also provided recommendations as to whether states had sufficient authority to implement successful retail competition programs.(5)

FERC has concluded that wide-spread structural and technical changes in the natural gas pipeline industry and in the electric power industry warrant unified and consolidated standards of conduct to govern the relationship between owners of natural gas pipelines and electric transmission facilities and their unregulated energy affiliates. There are two competitive concerns raised by the interaction between regulated transmission providers (whether they are electricity transmission or natural gas pipelines) and their unregulated affiliates.(6) First, it is possible that a transmission provider's market power (which FERC seeks to constrain through regulation) could be transferred to and exercised by its affiliated businesses because the existing standards of conduct do not cover all affiliate relationships by which discriminatory conduct could occur. This could occur, as FERC has noted, through the use of discriminatory information flows from utilities to their affiliates that are not covered by FERC's existing affiliate standards of conduct. Second, the transmission utility could engage in anticompetitive cross-subsidization in favor of its unregulated affiliates. This conduct adversely affects competition and economic efficiency. For example, cross-subsidization of an affiliate may allow a less-efficient affiliate to expand at the expense of more efficient non-affiliates. The result will be high average costs for the market served by the affiliate and its displaced competitors.

In the Notice, FERC contends that the existing gaps in application of affiliate standards of conduct can be addressed by "consolidating" the electric and gas standards of conduct, broadening the definition of the term "affiliate," narrowing the native load exception(7) applicable to electric utility transmission owners, and applying the standards uniformly to all transmission providers.(8) FERC's proposals also exempt transmission providers that are approved Regional Transmission Organizations (RTOs) from complying with the standards of conduct, but do not necessarily exempt individual members of RTOs if they manage or administer the transmission facilities themselves.

It is appropriate and timely for FERC to broaden and unify the coverage of its affiliate standards of conduct due to convergence of the natural gas and electric power industries and the subsequent growing importance of information flows to competition within and between both industries.(9) Our recent reviews of mergers between natural gas and electricity transmitting entities demonstrate the kind of competition occurring between the natural gas and electric power industries and the importance of protecting that competition.

We endorse FERC's proposal to eliminate the potential anticompetitive effects of a transmission owner's native load preference.(10) FERC has proposed to do this by requiring a utility to separate transmission functions from all wholesale and retail sales functions (including any information preferences that transmission personnel may provide to the vertically integrated utility's sales personnel). We recently concluded that providers of standard offer service in a competitive retail environment should not have preferential access to the transmission grid.(11)

In addition, FERC may wish to strengthen RTO arrangements rather than determine whether individual members of RTOs should be subject to the proposed standards of conduct (or other behavioral rules) as a remedy to weak RTOs. Structural remedies (such as effective RTOs) are more likely to alleviate anticompetitive discrimination and cross-subsidization within electric power markets than will the use of behavioral rules such as the proposed standards of conduct.(12)

II. Adjusting Affiliate Standards of Conduct to Take Account of Convergence Is Timely

An important change for both the natural gas industry and the electric power industry is convergence between demand for natural gas and electric power. This convergence is in large part due to technological improvements and innovations in natural gas-fueled generation. These improvements have included reductions in both the operating costs and efficient scale of natural gas-fueled generators. Potentially significant innovations in natural gas-fueled generation include fuel cells and microturbines that may be able to efficiently provide onsite power for an individual small business or residence on a full-time or on a part-time basis.(13) As a result of these technological improvements, natural gas is often the "fuel of choice" for onsite generation because natural gas is relatively clean burning and because a network to distribute natural gas to homes and businesses is already in place in many population centers. All of these improvements facilitate generation of electric power closer to centers of electricity demand.(14) These improvements and the convergence of the natural gas and electric power industries have interjected new competition into the electricity industry, potentially providing great consumer benefits. This new form of competition should be fostered and protected from affiliate abuse.(15)

In four recent investigations of proposed mergers, the FTC found substantial evidence of convergence between fuel markets and electric power markets. This convergence has raised significant competitive concerns and has showed the need for uniform regulatory treatment of electric affiliates of gas utilities and gas affiliates of electric utilities.(16) The most recent of these was the acquisition of MichCon, the local natural gas distribution company serving the Detroit area, by DTE, the local electric power distribution company.(17) The competitive concern raised by the proposed acquisition was that MichCon's incentives to serve and promote onsite generation and other natural gas substitutes for electric power would be curtailed once it became an affiliate of DTE. This potential curtailment was due to DTE's incentives to minimize such reductions in electric power demand from the DTE's electric distribution franchise (and DTE's predominant generation and transmission services). Based on strong indications of existing and potential customer demand that could be served by either natural gas or electric power distribution in the Detroit area, the FTC approved the acquisition only after the parties agreed to divest a portion of the MichCon natural gas distribution system to a new local natural gas distribution competitor. The divestiture was in the form of a perpetual easement agreement between DTE Energy and the entrant, Exelon.

The Commission confronted similar issues with the proposed acquisition of the Gulf South Pipeline Company, a major natural gas pipeline in Mississippi and Louisiana (owned by Koch), by the Entergy-Koch limited partnership.(18) Entergy is the principal electric power supplier/distributor and natural gas distributor in much of Mississippi and Louisiana. The Commission found that after the acquisition, Entergy would benefit from paying its new affiliate, Gulf South, an inflated price for gas supplies because Entergy could retain much of the profit from such an increase and, if undetected, pass the increased costs to ratepayers. To the extent that onsite generators in Mississippi and Louisiana would pay higher natural gas prices after the acquisition, Entergy also could benefit from higher demand for electric power (as existing and future onsite generation are curtailed due to higher natural gas prices). As a remedy, the Commission required increased disclosures and competitive natural gas purchasing procedures that would make inflated natural gas charges easier to detect by state regulators.

The third merger involved the purchase of Panhandle Eastern Pipeline Company and Trunkline LNG Company by CMS Energy Corporation, a combination electric and gas utility company serving broad areas of Michigan outside of the Detroit area.(19) The Commission alleged that CMS Energy would have the incentive and ability to unilaterally reduce or close the interconnection between its distribution system and the connecting natural gas pipelines it did not own. Further, state and federal regulatory agencies were unlikely to have authority to interdict this behavior. The result would likely be increased demand for transportation services on CMS's new affiliates, Panhandle and Trunkline, that would enable these natural gas pipelines to raise their rates. In addition, the proposed acquisition was likely to adversely affect industrial plants in the CMS local natural gas franchise areas that rely on natural gas as a fuel to generate electric power onsite. Increased gas transportation rates were likely to increase the cost of self-generation and may have forced these plants, instead, to purchase electric power from CMS. The settlement agreement with CMS curtails its ability and incentives to reduce or sever interconnections between its distribution system and pipelines it does not own.

Lastly, in the PacifiCorp/Peabody Coal case, raising rival's cost and anticompetitive access to proprietary information of rivals were the principal competitive concerns.(20) Specifically, the acquisition of Peabody Coal as an affiliate by the electricity supplier and distributor PacifiCorp would have created the incentive and ability for PacifiCorp to raise electricity prices in the West by raising the fuel (coal) costs at two large power plants owned by wholesale power competitors of PacifiCorp. Further, access to proprietary information about fuel use at these and other plants could have given PacifiCorp an information advantage in electricity markets that would allow it to profitably bid less aggressively, thereby raising wholesale prices (and, ultimately, retail prices for consumers). Although the fuel involved in this case was coal, rather than natural gas, the same conceptual concerns apply to a firm's control over natural gas that is essential to a competitor in electric power markets.

These individual case experiences support FERC's concern about potential anticompetitive discrimination between transmission providers and energy affiliates. This is even more important now that there is substantial convergence between the electric power and natural gas industries and this significant competition merits protection.

III. FERC Should Eliminate the Potential Anticompetitive Effects of the Native Load Preference

Currently, FERC's electric transmission open-access policy applies to two types of transmission sales: (1) wholesale sales of unbundled transmission services (i.e., when transmission services are sold by and between wholesale suppliers separately from generation services); and (2) retail sales of unbundled transmission services (i.e., when transmission services are sold independent of generation to retail customers). The open access requirement does not apply when the owner of the transmission facilities is providing bundled service to its native load customers. For this use, the transmission owner may have preference to the transmission grid over non-affiliated entities.

We found in our investigation of state retail electricity programs that the analog to native load service in a retail competition environment is standard offer service. States typically have required distribution utilities to provide customers standard offer service to those customers that have not selected an alternative electricity supplier, or whose electricity supplier has exited the market. The September 2001 FTC Staff Report noted that certain states, which have introduced retail competition, have not afforded standard offer service providers preferential access to the transmission grid if an Independent System Operator (ISO) in place.(21) Once RTOs are operational and are using market mechanisms to manage transmission congestion to ensure efficient transmission pricing, there will be no need for a native load preference. To this end, we support FERC's proposal to reign in potential anticompetitive effects of the native load preference by, among other things, ensuring that utility employees responsible for securing native load supplies, do not have preferential access to transmission information.

IV. Stronger RTOs May Be Preferable To Relying on Broader Application of Behavioral Rules to Deficient RTO Arrangements

FERC has proposed to require members of RTOs to comply with the proposed standards of conduct if the member still has physical control over transmission assets and, importantly, direct access to transmission information. Where RTO arrangements potentially allow anticompetitive discrimination by virtue of continued physical control over transmission assets, it is reasonable for FERC to seek to prohibit such discrimination.(22) FERC's proposed remedy of applying the affiliate standards of conduct in such situations, however, may be less effective than strengthening the underlying weaknesses in RTO arrangements.(23)

When an RTO member retains control over transmission operations (and, in some cases, information), incentives and opportunities for anticompetitive discrimination may persist within an RTO.(24) Similar concerns arise if RTOs are not fully effective (i.e., independent of transmission owners that also control generation in the same area).

The limited success of behavioral rules in securing open access in transmission services argues strongly for strengthening RTO structural requirements rather than attempting to patch deficient RTO provisions with existing or consolidated behavior rules for energy affiliates. The September 2001 FTC Staff Report (Chapter II) provides further support for this conclusion. The Report discussed how areas with active structural separation of transmission from generation through Independent System Operators had more effective wholesale competition and a better opportunity to establish effective retail competition. It is critical for the RTO formation process to move forward to assist development of competitive electric power markets and to minimize backtracking. It would be unfortunate for progress in the RTO formation process to be turned back due to weaknesses in RTO arrangements that affiliate standards of conduct may not effectively remedy.

V. Conclusion

Based on our antitrust merger review experience, the potential anticompetitive discrimination due to convergence between the natural gas and electric power industries shows that FERC's proposal to broaden and unify the coverage of its affiliate standards of conduct is appropriate and timely. If affiliate standards of conduct are relied upon to discourage potential anticompetitive discrimination between the natural gas and electric power industries, FERC's proposals to broaden the application of these standards of conduct to all energy affiliates is reasonable. Moreover, we support eliminating potential anticompetitive effects of the native load preference that electric transmission providers currently maintain. This will help ensure more robust wholesale, and retail, electric markets.

We also agree with FERC's concern that under some proposed RTO structures, RTO members may have continued incentives and ability to engage in anticompetitive discrimination favoring their energy affiliates. Where proposals with such provisions continue to be made, FERC may wish to insist that RTOs be fully effective by not accepting such proposals, rather than rely on broader application of affiliate standards of conduct as a remedy. Stronger RTO requirements are more likely to be effective because they more thoroughly remove incentives to engage in anticompetitive discrimination than do the affiliate standards of conduct.

Respectfully submitted,

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Endnotes:

1. See endnote 2.

2. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission and the staff of the General Counsel's Office of Policy Studies. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. The Commission has, however, voted to authorize the staff to submit these comments. Inquiries regarding this comment should be directed to John C. Hilke, Economist and Electricity Project Coordinator in the Bureau of Economics (801-524-4440 or jhilke@ftc.gov) or Michael Wroblewski, Assistant General Counsel for Policy Studies (202-326-2155 or mwroblewski@ftc.gov).

3. 66 Fed. Reg. 50919 (Oct. 5, 2001) (Notice).

4. FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (Jul. 2000) http://www.ftc.gov/be/v000009.htm. This report compiles previous comments that FTC Staff had provided to various state and federal agencies. For example, FTC Staff has commented to FERC on electric power regulation in Docket No. RM99-2-000 (regional transmission organizations) (Aug. 16, 1999); Docket EL99-57-000 (Entergy transco proposal) (May 27, 1999); Docket RM98-4-000 (Sept. 11, 1998) (merger filing guidelines); Docket No. PL98-5-000 (May 1, 1998) (ISO Policy); Docket Nos. ER97-237-000 and ER97-1079-000 (New England ISO) (Feb. 6, 1998); Docket No. RM96-6-000 (merger policy) (May 7, 1996); Docket Nos. RM95-8-000 and RM94-7-001 (open access) (Aug. 7, 1995). The FTC staff comments are available at: http://www.ftc.gov/be/advofile.htm

5. FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform, Focus on Retail Competition (Sep. 2001) http://www.ftc.gov/reports/index.htm.

6. *Id*. at 13.

7. The native load exception allows a utility (the transmission provider) to bundle electricity and transmission services and to have preferential access to the transmission grid (over non-affiliated grid users) to serve its captive retail customers.

8. Notice at 50922.

9. To the extent that FERC's proposal would govern the relationship between transmission providers and affiliates that do not rely on the transmission provider's services, assets or facilities, FERC may wish to determine whether the benefits of applying the affiliate standards of conduct outweigh the compliance costs and lost integration efficiencies associated with these rules.

10. The native load exception to FERC's open access requirement occurs when the owner of transmission facilities provides bundled service (when transmission and generation suppliers are sold together) to its retail customers. States that have moved toward retail competition have generally eliminated the native load exception. September 2001 FTC Staff Report at 20.

11. Standard offer service in a competitive environment is comparable to native load service in a wholly-regulated environment. States typically require distribution utilities to provide standard offer service to customers that do not select an alternative electricity supplier or whose supplier has exited the market.

12. This issue is discussed in the July 2000 Staff Report at 13-18.

13. If real-time retail prices reflect real-time wholesale prices, owners of onsite generators will have strong incentives to run these generators during peak demand periods. This will reduce demand from the grid during peak demand periods when wholesale prices are high. See September 2001 FTC Staff Report at 34-7.

14. *See* September 2001 FTC Staff Report at 28; Consumer Energy Council of America, *Distributed Energy: Towards a 21st Century Infrastructure* (Jul. 2001).

15. *See* note 8, *supra*.

16. Other nonpublic investigations have reinforced such concerns.

17. In the Matter of DTE Energy Company and MCN Energy Group, Inc., File No. 0010067, Analysis of the Proposed Consent Order and Draft Complaint to Aid Public Comment www.ftc.gov/os/2001/03/dreanalysis.htm.

18. In the Matter of Entergy Corporation and Entergy-Koch, LP, FTC Docket No. C-3998 www.ftc.gov/opa/2001/01/entergy.htm.

19. In the Matter of CMS Energy Company and Panhandle Eastern Pipeline Company et al., FTC File 991 0046, Analysis of Proposed Consent Order to Aid Public Comment www.ftc.gov/os/1999/03/cmsanalysis.htm.

20. In the Matter of PacifiCorp and The Energy Group PLC, Analysis of Proposed Consent Order to Aid Public Comment www.ftc.gov/os/1998/02/9710091.ana.htm.

21. September 2001 FTC Staff Report at 21. In the Staff Report, we also described that when access to the transmission grid is based on nondiscriminatory rates, rather than on artificial preferences, the grid will operate more efficiently. We understand FERC is currently not proposing to assert jurisdiction over the transmission rates used to support bundled retail sales, as this issue is currently on appeal to the U.S. Supreme Court in New York et al. v. FERC (00-0568) and Enron Power Marketing Inc. v. FERC (00-0809).

22. In this and other contexts, we encourage FERC and the states to utilize a cost/benefit framework in which potential costs, such as loss of efficiencies from vertical integration and administrative costs, are taken into consideration relative to the benefits such as reduced discrimination or enhanced competition.

23. Although FERC has not sought to implement structural alternatives to affiliate codes of conduct in the natural gas pipeline industry, FERC may wish to be attentive to such alternatives if they would provide greater benefits and lower costs.

24. Notice at 50922.