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

Before the Georgia Public Service Commission

Docket Number 15640-U

Standards for Determining Whether Natural Gas Prices Are Constrained by Market Forces

Comment of the Staff of the
Bureau of Economics and the Office of the General Counsel
Federal Trade Commission(1)

I. Introduction

The staff of the Bureau of Economics and of the Office of the General Counsel of the Federal Trade Commission (FTC) appreciates this opportunity to present its views to the Georgia Public Service Commission (GPSC) about the GPSC's proposed standards for determining whether prices for natural gas paid by retail customers are "constrained by market forces" and, when they are not, for determining whether they are "significantly higher than such prices would be if they were constrained by market forces."(2) In addition to the provisions regarding price levels, the GPSC's proposals(3) and the authorizing statute(4) provide for a separate rebuttable presumption that retail market conditions are not competitive if more than 90 percent of firm retail customers in a specific delivery group are served by three or fewer retail marketers. The GPSC may intervene in retail natural gas pricing if either set of conditions is satisfied.(5)

We offer views on the GPSC's proposal from the perspective of the FTC's fundamental mission of preserving competition in the marketplace. Our competitive analysis framework is presented in the U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (Horizontal Merger Guidelines).(6) Competition is the cornerstone of our economy. Where there is vigorous competition among sellers, consumers are likely to benefit from lower prices, higher quality, wider variety, and greater innovation.

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. The staff of the FTC often analyzes regulatory or legislative proposals that may affect competition in this industry, 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 of competition issues.

FTC staff has commented extensively on the market power issues raised by state retail restructuring plans for the electric power industry. Many of the issues confronting state regulators as they move from a regulated monopoly model to a competitive model for retail sales of electricity also are present in restructuring retail sales of natural gas. The Commission has released 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.(7) 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.(8) The FTC also has reviewed proposed mergers involving natural gas pipelines and those involving electric and gas utility companies.

The FTC has conducted several investigations involving the natural gas industry that have focused on market power issues. The most recent, publicly disclosed case of this type involved a proposed merger between an electric power distributor (DTE) and a natural gas distributor (MichCon) that both serve the Detroit, Michigan, area.(9) The case was settled with a consent agreement by which the acquirer, DTE, divested a perpetual right to use a portion of MichCon's natural gas distribution system in the Detroit area to a new entrant. The settlement was modeled on release capacity arrangements, which were effectively implemented previously for interstate natural gas pipelines.

In addition, the Commission has recently concluded two investigations of competition in certain gasoline markets. Some aspects of market structure and market dynamics in gasoline markets may be similar to those in the Georgia retail natural gas industry. In March 2001, using the competition analysis principles in the Horizontal Merger Guidelines, the Commission completed an investigation of a spike in reformulated gasoline (RFG) prices that was observed in several Midwest states during the spring and summer of 2000.(10) In May 2001, the Commission closed an investigation of West Coast gasoline markets designed to determine whether observed price differences between metropolitan areas, service disruptions, and abrupt price increases at the refiner, wholesale, and retail levels were the result of illegal conduct by the West Coast refiners.(11)

II. Background of the Proposed Standards

In 1997, the Georgia Legislature established a new regulatory model in Georgia's retail natural gas industry. The Legislature allowed regulated vertically integrated natural gas utilities to unbundle distribution functions from retail sales. "When a company elects to unbundle its distribution and sales functions, as Atlanta Gas Light Company (AGLC) did, the industry is effectively separated into two sectors. One sector, the distribution infrastructure and operations, is assumed to retain the natural monopoly characteristics that require traditional regulation, while the other sector, commodity sales, is assumed to be potentially competitive."(12) In retail commodity sales, prices for natural gas are determined by competition rather than set by regulation. After many reported ups and downs associated with being the first state in the Nation to remove the distribution utility from the natural gas merchant function, the marketplace had winnowed the number of major competing retail marketers in Georgia to four by early 2002.(13)

In April 2002, the Legislature amended the statutory framework governing the regulation of the retail natural gas industry (HB 1568) to address many of the reported problems that had surfaced in the first several years of deregulation. Among other things, it established a default service provider for certain classes of customers and provided customers with a "bill of rights" for natural gas services. The Legislature also authorized the GPSC temporarily to reimpose price regulation on natural gas marketers if prices "are not generally constrained by market forces."(14) The legislation includes a rebuttable presumption that market conditions are not competitive - and thus that retail prices are significantly higher than they would be if they were constrained by market forces - if more than 90 percent of the consumers in a specified delivery group (e.g., residential consumers) are served by three or fewer marketers.(15) This measure of market structure is a three-firm concentration ratio.

Aside from the rebuttable three-firm 90 percent market share screen for market power, the legislation identified additional circumstances in which intervention by the GPSC is authorized. It permits the GPSC to adopt standards for determining whether prices paid by retail customers are "not constrained by market forces" and are "significantly higher than such prices would be if they were constrained by market forces." Under the GPSC's proposal, retail natural gas prices will be viewed as not constrained by market forces if "reasonably prudent" firm retail customers(16) in a specific retail delivery group are substantially harmed by market power. The present matter is the third phase of the GPSC's proceedings to determine the standards to implement this aspect of the legislation.

The GPSC proposes to intervene "as narrowly as possible" in retail pricing of natural gas if it finds that prices paid by a specific retail customer delivery group are "not constrained by market forces" and if it finds that prices are "significantly higher" than they would be if constrained by market forces. In the first stage of its analysis to determine if prices are constrained by market forces, the GPSC may take into account barriers to customer switching, the degree to which alternative choices exist, and the amount of information available to these retail customers about alternative choices.

In the second stage of its analysis to determine if prices are substantially higher than competitive prices and harmful to the affected customers, the GPSC will determine whether one of three price triggers is reached: (1) prices exceed a competitive benchmark by 20 percent over the prior 12 months; (2) prices exceed a competitive benchmark by 30 percent over the prior three months; or (3) current prices exceed a competitive benchmark by 50 percent. The GPSC does not state specifically how it will calculate the competitive benchmark, but it provides a list of cost factors, comparisons to prices in other jurisdictions, and business risk factors that it may consider in making such a determination.

III. The GPSC's Intervention Should Be Narrow and Short-Lived

We recognize the substantial impact that the exercise of supplier market power can have on consumers, and we agree that regulatory intervention, if any, to address this situation should be as narrow as possible. During the transition from a regulated to a deregulated environment, consumers are likely to learn to be more effective shoppers for a commodity that was previously regulated. In addition, during this period potential suppliers may not yet have entered.(17) If the GPSC adopts the present proposal or a modification of it, the GPSC may wish to consider conducting a sunset review of these provisions once the transition period is over.(18)

For purposes of this comment, we take no position on the statutory provision establishing the rebuttable three-firm 90 percent market share screen. We do observe, however, that the competitive implications of high concentration among firms in a market depend critically on other conditions in the market. Under the Horizontal Merger Guidelines, the presumption that high concentration is associated with market power is often rebutted by evidence that entry is timely, likely, and sufficient(19) or that anticompetitive effects are unlikely for other reasons, such as the ability of smaller incumbent suppliers to expand output quickly.(20) Either of these may make efforts to exercise market power unprofitable.(21) In addition, market share and market concentration data may either underestimate or overestimate the likely state of competition in a market.(22)

Although we do not take a position on the costs and benefits of triggered reimposition of price regulation in the Georgia retail natural gas industry, a couple of years ago we argued to the Federal Energy Regulatory Commission that regulatory caps on prices are likely to have significant costs because they tend to curtail entry and reduce investment incentives.(23) Diminished entry and investment incentives, in turn, are likely to lead to reduced supply and higher market-determined prices.

If the GPSC determines to move forward with provisions for triggered intervention in retail natural gas prices, such intervention should be as narrow and short-lived as possible. To accomplish this, the GPSC may wish to avoid interventions that exceed the time necessary for effective entry to take place. One of the principal risks of intervening to limit retail price increases is that the intervention will be more severe and last longer than necessary to alleviate a short-term exercise of market power. Long-term and drastic price interventions are particularly likely to suppress market signals that otherwise would elicit new entry as well as expansions of capacity and output by incumbent firms. Consequently, the unintended outcome of a too-drastic intervention may be to increase or to entrench market power.

IV. The GPSC's Proposed "Prudent Customer" Standard Should Accurately Reflect Customer Behavior

The GPSC's proposal to use a "prudent customer" standard for assessing whether prices are constrained by market forces should accurately identify circumstances in which the exercise of significant market power is likely. In assessing market power issues, one should focus on whether a sufficient number of customers would switch to other sources of supply in response to a significant anticompetitive price increase, so that the price increase would be unprofitable. This involves an empirical investigation of how consumers behave. Thus, the "prudent customer" standard should incorporate whether this behavior would occur. One of the virtues of markets is that the actions of a relatively small share of customers who would switch in response to price increases often protect other customers - potentially even the majority of customers - who may not have the same ability or willingness to switch.(24)

Because customer choices can have dramatic effects on efforts by incumbent suppliers to exercise market power, the GPSC may wish to evaluate impediments to customer choice. Important issues to consider include barriers to customer switching, the degree to which alternative choices exist, and the amount of information available to retail customers about such alternatives. The GPSC may wish to expand this list or expand its discussion of alternatives to include entry conditions. This would signal to marketers and potential entrants that the GPSC recognizes how entry can dramatically increase customer choices in the face of efforts by one or more incumbent suppliers to exercise market power.

V. Link Market Power Concerns to Structural Remedies and Customer Price Sensitivity, Not Just Behavioral Remedies

The GPSC's proposal contemplates a temporary return to retail price regulation if (under the criteria it adopts) the GPSC determines that suppliers are exercising substantial market power. Price regulation is a behavioral remedy for market power that leaves in place incentives to exercise market power. Our experience in antitrust law enforcement and competition advocacy suggests that structural remedies are preferable to behavioral remedies because the former change suppliers' incentives and are, therefore, largely self-enforcing.(25) Structural remedies change the competitive dynamics of a market by changing the number or relative positions of firms, either directly or by reducing impediments to entry. Accordingly, if the GPSC finds evidence of market power problems, it may wish to review its policies that affect market structure.(26) In particular, if the GPSC finds evidence of nontransitory market power in retail natural gas markets, it may wish to examine whether its policies (or those of other regulatory bodies) are impeding entry or discouraging investments that would increase competition by adding new retail suppliers or removing supply bottlenecks.

Similarly, the GPSC may wish to bolster customers' ability to defend themselves against market power. Policies to improve customer information, and to reduce regulatory lags and costs for customers switching to marketers with lower prices, can serve this purpose by making customers more sensitive to prices, which would increase the price elasticity of demand. A higher price elasticity of demand will reduce the profitability of a retailer's efforts to exercise market power through higher prices.

VI. Conclusion

The GPSC proposes a two-step analysis that may trigger its temporary intervention in retail natural gas markets. In the first phase, the GPSC proposes to assess whether prudent retail customers would be harmed by suppliers' efforts to exercise market power. We suggest that in assessing the likelihood of significant market power, the GPSC should consider not only market concentration but also the extent to which an anticompetitive price increase would cause consumers to reduce their purchases from the larger incumbents, smaller sellers to expand, and new sellers to enter. In the second phase, the GPSC would assess how actual prices compare to a competitive benchmark. We suggest that if the GPSC has evidence of substantial, nontransitory market power in retail natural gas markets, it should consider structural remedies. In particular, the GPSC may wish to review policies that may maintain supply bottlenecks by impeding entry or investments. Regulations affecting customer access to pricing information and switching costs are also likely to be relevant.

Respectfully submitted,

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Endnotes:

1. This comment represents the views of the staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. The Commission, however, has voted to authorize the staff to submit this comment. 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).

2. Notice of Public Rulemaking (NOPR), §§ 515-7-12-.01(1),(2), and (4).

3. NOPR, § 515-7-12-.01(3).

4. HB 1568, "Natural Gas Consumers' Relief Act," § 13 (enacted Apr. 25, 2002).

5. The intervention could take the form of price regulation applied to retail marketers (NOPR, § 515-7-12-.01(2)) or mandatory vertical integration of the regulated natural gas distribution firm into regulated retail commodity sales (NOPR, § 515-7-12-.01(1)).

6. The Horizontal Merger Guidelines were published on April 2, 1992, and revised on April 8, 1997, *available at* <http://www.ftc.gov/bc/docs/horizmer.htm>.

7. FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (July 2000), *available at* <http://www.ftc.gov/be/v000009.htm>.

8. FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform, Focus on Retail Competition (Sept. 2001), *available at* <http://www.ftc.gov/reports/index.htm>.

9. The FTC was concerned that the merger would reduce competition (for example, by reducing discounts offered by MichCon to customers contemplating investments in on-site electricity generation fueled by natural gas), because DTE and MichCon competed against each other for customers who have a choice between distribution services for electricity or natural gas. The case, its issues, and the innovative terms of settlement are described in John C. Hilke, *Convergence Mergers, A Competitive Settlement for Detroit*, 14 Electricity Journal 13 (Oct. 2001).

10. Midwest Gasoline Price Investigation, Final Report of the Federal Trade Commission (Mar. 29, 2001), available at <http://www.ftc.gov/os/2001/03/mwgasrpt.htm>. In its report, the Commission noted the price spike "appears to have been caused by a mixture of structural and operating decisions made previously (high capacity utilization, low inventory levels, the choice of ethanol as an oxygenate), unexpected occurrences (pipeline breaks, production difficulties), errors by refiners in forecasting industry supply (misestimating supply, slow reactions), and decisions by some firms to maximize their short-term profits (curtailing production, keeping available supply off the market)." Id. at 3. The Commission found no credible evidence of collusion or other anticompetitive conduct by the oil industry in its investigation of the price spike in the Midwest.

11. FTC Press Release: FTC Closes Western States Gasoline Investigation (May 7, 2001), available at <http://www.ftc.gov/opa/2001/05/westerngas.htm>. In this matter, the Commission was asked to investigate solely whether there was an antitrust violation. The investigation produced no evidence of conduct that violates the antitrust laws.

12. GPSC Staff White Paper, § I (Jan. 2003). One novel feature of the Georgia restructuring was that all retail customers selected or were assigned to a merchant natural gas supplier. No provider-of-last-resort arrangement was provided for customers who did not select a merchant supplier on their own.

13. Blue Ribbon Natural Gas Task Force, Final Report at 9 (Feb. 5, 2002). Several smaller retail marketers also are active in Georgia. These include two recent entries by electrical cooperatives under the provisions of HB 1568, § 20.

14. HB 1568, § 13. This legislative language is reflected in NOPR, § 515-7-12-.01(1)(b), (2), and (4).

15. HB 1568, §13; NOPR, § 515-7-12-.01(3) reflects this aspect of the legislation.

16. A "firm" retail customer is one whose supply contract does not allow for interruptible service (where the supplier curtails deliveries under a variety of circumstances, usually in return for a lower price on deliveries that do occur). A customer with the latter type of contract is termed an "interruptible" customer.

17. Entry delays may result in high concentration when a market first opens. Some entrants' efforts to attract customers may take time to be effective, and some potential entrants may wait to enter until after initial regulatory uncertainties are resolved.

18. A sunset review may be particularly appropriate as some retail marketers work increasingly over time to differentiate themselves from other retail marketers. This product differentiation could be based, for example, on the quality of service or on service innovations. With such product differentiation, prices may increase because customers prefer retail marketers that offer better or innovative services, even if they charge higher prices. For example, some marketers may offer a service that bundles commodity sales with insurance against volatility in natural gas prices. When natural gas prices are below historic averages, the price of this bundled product could far exceed prices that do not include an insurance component. If such bundled services become popular, it could lead in the future to actual prices that exceed the trigger prices but do not reflect an exercise of market power. If such differentiation becomes a prominent feature in Georgia retail natural gas sales, the proposed approach may become an impediment to satisfying customer preferences.

19. Horizontal Merger Guidelines, § 3.

20. *Id.*, § 2.212.

21. *Id.*, §§ 1.521 and 3.

22. For example, changing market conditions may indicate that the current market share of a particular firm understates or overstates its future competitive significance. This is illustrated by a firm that does not have access to new technology that is important to long-term viability of market participants. In this instance, the current share of the firm in question is likely to overstate its future competitive significance. *Id.*, § 1.521. Similarly, the closeness of substitutes outside the market may affect the significance of a particular concentration measure. Where a wide gap in the chain of demand substitutes occurs at the edge of the product and geographic markets, more market power is at stake in the relevant market than in a market in which a hypothetical monopolist would find it profitable to raise price by a small amount (5 percent). *Id*., § 1.522.

23. Comment of the Staff of the Bureau of Economics and of Policy Planning, FERC Docket Nos. EL00-95-000 et al. (Nov. 22, 2000), *available at* <http://www.ftc.gov/be/v000015.pdf>.

24. For a discussion of consumer self-defense in the context of electricity retail markets, see John C. Hilke, *A Consumer Self-Defense Perspective on Electricity Markets*, 33 Loy. U. Chi. L.J. 805 (2002). This limitation on the exercise of market power provided by the switching of a small share of customers is less likely to protect other customers if suppliers can profitably price discriminate.

25. We have identified four principal concerns about relying on behavioral market monitoring approaches to remedying market power. First, many exercises of market power are likely to be difficult to detect and document. Second, behavioral rules will not eliminate incentives to exercise market power. Third, behavioral rules create a risk that certain procompetitive (or competitively neutral) behavior will be misidentified as anticompetitive, thus chilling competition and increasing administrative and litigation costs. Finally, focusing on behavioral remedies may divert attention from structural remedies that have the potential to address market power with greater certainty and lower costs to consumers. See FTC Staff Comment, FERC, Docket No. PL98-5-000 (Inquiry Concerning Independent System Operators) (May 1, 1998), *available at* <http://www.ftc.gov/be/hilites/isodraf3.htm>.

26. Such policy reviews could be carried out periodically as well as when specific market power concerns arise.