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

Before the Illinois Commerce Commission

Docket Number 03-0083

Application for Approval of Asset Transfer Agreements with Affiliated Company

Ameren Union Electric Company

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 Illinois Commerce Commission (ICC) concerning the competition issues raised when a regulated electric utility seeks to transfer to the parent utility generation assets that it previously spun off to an unregulated affiliated company in the same geographic area.(2)

Often acquisitions and asset transfers pose no threat to competition and may in fact enhance competition and benefit consumers. Nevertheless, we address how the type of transaction in this matter could change incentives in two ways that could potentially harm competition and customers. The first is the incentive of a regulated parent utility with unexercised market power to evade cost-based rate regulation by transferring assets of an unregulated affiliate to the parent utility's rate base at inflated prices. The second is the increased incentives or ability of the parent utility to discriminate vertically against independent generators or marketers. We do not take a position on the facts of the present matter, but we encourage the ICC (or any regulatory body facing this type of application(3)) to consider how such changed incentives affect customers and competition.

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of customers. In the energy 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 of 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 analyzed whether states had sufficient authority to implement successful retail competition programs.(5)

II. Does the Proposed Acquisition Facilitate Evasion of Cost-Based Rate Regulation Through the Transfer of Assets to the Parent from the Affiliate at Inflated Prices?

In a state with cost-based rate regulation of retail utility prices in which the regulated utility has market power, some mechanism is appropriate to assure that asset transfers from an affiliated generator to a parent utility, for example, do not take place at inflated prices. Rate-regulated parent utilities with market power have incentives to make such transfers. The costs of the inflated asset base for the regulated utility would be covered by higher regulated rates while the gains from the asset sale at an inflated price would be realized by the affiliate outside of the scope of the regulator's cost-based rate determination. A transfer at an inflated price would be a form of regulatory evasion because it would result in the exercise of market power, with captive customers paying higher regulated rates to cover the regulated utility's inflated costs of acquiring generation capacity. These higher regulated rates are likely to distort customers' investment incentives(6) and their consumption decisions. In the case of the former, the harm can persist long after the rate effects have ceased if the investments made on the basis of distorted price incentives remain in the market.

Establishing market values for affiliate transactions can be accomplished in several ways including putting some of the assets up for sale, doing a "comparables" analysis (including using econometric techniques to develop an estimated market price based on recent sales prices of similar properties), or doing a discounted cash flow analysis of expected earnings. All of these approaches present challenges, but they are likely to be more accurate than using historic book values alone to estimate the market value of affiliates' assets.(7)

III. Will Rebundling Result in the Loss of Benefits Gained by Vertically Unbundling?

Numerous state utility regulators have required electric utilities to unbundle generation from transmission, to place generation assets into unregulated affiliates, and to impose a code of conduct that governs the interaction between unregulated affiliates and the parent utility. These actions are often undertaken as a remedy against discrimination and/or cross-subsidization by a parent utility favoring an affiliated, unregulated generator or marketer. Such discrimination or cross-subsidization can competitively disadvantage equally or more efficient independent generators and marketers and lead to higher system costs, less innovation, lower service quality, and reduced variety of available services for customers.(8) If the discrimination or cross-subsidization results in an increase in market concentration or a reduced probability of effective entry within an already highly concentrated market, additional harm to customers may occur because of increased exercise of horizontal market power by suppliers.

In a retail competition setting, for example, discrimination may allow the parent utility to preserve or enhance its overall profits by increasing the marketing costs of unaffiliated retail power marketers. One means of accomplishing this objective could be to provide slower or less accurate retail customer switching procedures and services to prospective customers of unaffiliated retail power marketers and associated generators than the parent utility provides to the prospective customers of it own retail marketing affiliate.(9)

Another potentially profitable form of discrimination may occur when the parent utility is subject to cost-based rate regulation that results in underpricing of a service for which there is an excess demand at the regulated price. In such circumstances, the parent utility can discriminate by giving its affiliate priority to this service. In effect, this strategy reduces the affiliate's costs relative to the costs of competing independent suppliers.

A parent utility whose ability to exercise market power is constrained by cost-based rate regulation also may find it profitable to cross-subsidize its unregulated affiliates. As an alternative way to slow the net switching of retail customers to independent retail marketers, the regulated utility could cross-subsidize the processing of requests from retail customers to switch to the affiliated retail marketer from independent retail marketers. This could be accomplished, for example, by disproportionately devoting parent utility personnel to processing requests to switch to the affiliated marketer.

One way to analyze the competitive impacts of a transfer of the assets of an affiliated generator to the parent utility is to determine whether benefits from increased competition between generators have been gained from vertically unbundling these assets. If there are such benefits, state utility regulators could apply a similar economically appropriate analysis to the rebundling of assets and associated remedies. For example, state or federal regulators may have relied on unbundling of transmission from generation assets to prevent or eliminate discrimination or cross-subsidization from the regulated parent utility to the unregulated generation affiliate. If so, then rebundling may pose a risk of increased discrimination or cross-subsidization (and associated loss of efficiency) and should be analyzed accordingly. The ICC may wish to consider a policy based on consistent regulatory treatment of unbundling and rebundling.

In general, there is a hierarchy in the effectiveness of different vertical unbundling policies,(10) although the relative costs of these remedies vary in different circumstances.(11) Full divestiture is likely to be the most effective remedy since it directly changes the profit incentives of firms.(12) Divestiture to an affiliate (with accompanying conduct codes prohibiting discrimination as well as separate accounting for the affiliate) is likely to be less effective because the incentives to discriminate and cross-subsidize remain in place and enforcement of such codes may be costly and subject to error. Accounting separation alone is likely to be the least effective because behavioral incentives to discriminate and cross-subsidize remain in place with no countervailing behavioral restrictions.(13)

In a context where the parent regulated utility has an incentive to discriminate or cross-subsidize, the transfer of assets of an affiliated generator to the parent utility means a movement toward relying on accounting separation as the primary policy instrument against discrimination and cross-subsidization. Where actual and potential discrimination and cross-subsidization issues are significant - and where costs of implementing more effective remedies are not disproportionately high -- moving toward an accounting separation enforcement mechanism may threaten competition and promote inefficiency.

IV. Conclusion

The transfer of the assets of an affiliated generator to its parent utility may threaten to increase the exercise of the utility's market power. This may occur either by increasing the incentives to evade regulation or by enhancing the incentives and ability to vertically discriminate against independent generators (and marketers) or to cross-subsidize the affiliate. We encourage the ICC to evaluate both potential sources of customer harm in this and similar proposed transactions. One useful approach may be to consider unbundling and rebundling as equal but opposite transactions.

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. On May 30, 2003, AmerenUE filed a notice of withdrawal of its application in this proceeding. Nonetheless, we believe the comment may continue to be of interest to the ICC when it considers similar applications in the future.

3. FERC's Cinergy decision (FERC Docket No. EC02-113-000) of February 4, 2003, for example, raises similar issues. We observe that recent low or falling wholesale electric power prices may create financial distress for generation affiliates that may make rebundling financially attractive to the regulated parent utility. These same conditions, however, are likely to make the prices of the assets or supply contracts of independent generators more attractive as well.

4. FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (July 2000), *available at* <http://www.ftc.gov/be/v000009.htm>. This report compiles previous comments that the FTC staff provided to various state and federal agencies. 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 (Sept. 2001), *available at* <http://www.ftc.gov/reports/elec/electricityreport.pdf>.

6. Customers' incentives to invest in, for example, energy efficient appliances, on-site generation, and machinery powered by energy sources other than electricity are all affected by retail electricity prices.

7. Similarly, most states that undertook retail customer choice programs were reluctant to rely solely on book value (generally purchase price less depreciation) of stranded generation assets in evaluating the magnitude of stranded costs and instead employed a variety of evaluation techniques to estimate the market value of these assets. The stranded cost recovery approaches of several states are described in Appendix A of the September 2001 FTC Staff Report. *See also* Protest of the Electric Power Supply Association, *In re Cinergy Services, Inc.*, FERC Docket No. EC02-113-000 at Section 2 (filed Oct. 7, 2002), *available at* <http://www.epsa.org/Positions/FERC.cfm?what=796&docBody=3225>.

8. *See* July 2000 FTC Staff Report, Chs. III and IV. *See also United States v. Western Electric Co.*, 673 F. Supp. 525, 568 (D.D.C. 1987) (the antitrust lawsuit that led to the breakup of the Bell telephone system in which the Department of Justice alleged, among other things, that the Bell System had discriminated against rivals and engaged in cross-subsidization).

9. Vertical discrimination or cross-subsidization may take a wide variety forms - for example, discriminatory access to transmission, more timely available transmission capacity information provided to affiliates, discriminatory transmission line relief decisions, or cross-subsidization of affiliate operations. *See* July 2000 FTC Staff Report, Ch. III. Additional forms of potential discrimination arise primarily in the context of retail customer choice programs, including, for example, more (or quicker) access to customer information for affiliates, higher charges or lower-quality distribution service provided to customers of independent marketers and generators, and longer lags in switching retail customers to independent marketers and generators. Concerns about vertical discrimination and cross-subsidization are reduced to the extent that parent utilities strictly adhere to merit-based purchasing of generation services.

10. In comments to various states regarding forms of vertical unbundling, the FTC staff has recommended that decision makers employ a cost/benefit framework for evaluating alternative reforms. See July 2000 FTC Staff Report, Chs. III & IV.

11. Our general view is that functional unbundling (through affiliate relationships) often is not credible as an alternative to full divestiture or another structural remedy. The FTC staff comment on then-proposed Order 888

(FERC Docket Nos. RM95-8-000 and RM94-7-001, filed Aug. 7, 1995) identified operational unbundling (through an independent system operator having control of the transmission grid) as a form of structural unbundling even though regulated utilities continued to own both generation and transmission assets in the same area. Section II.D of the FTC staff comment on FERC's Working Paper on Standardized Transmission Service and Wholesale Electric Market Design (FERC Docket No. RM01-12-000, filed July 23, 2002) discussed medium- to long-term forward contracting as a potential structural remedy because it may transfer effective control of generation capacity from the owner of the generator to a customer or an independent supplier.

12. In the example above, divestiture would eliminate the profitability of delaying a customer's switch to independent retail power marketers. Because it removes or diminishes the underlying profit incentives to discriminate (or cross-subsidize), the divestiture remedy is likely to be self-enforcing.

13. A useful discussion of various forms of unbundling and a summary of evidence about the relative effectiveness of these remedies appears in the Organisation for Economic Co-Operation and Development Policy Brief: "Restructuring Public Utilities for Competition" (Apr. 2002), *available at* <http://www.oecd.org/pdf/M00026000/M00026489.pdf>.