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

Before the
Louisiana Public Service Commission
Baton Rouge, Louisiana 70821

Affiliate Relationships

Docket Number U-21453

Comment of the Staff of the
Bureau of Economics
of the Federal Trade Commission(1)

October 30, 1998

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to provide its views to the Louisiana Public Service Commission (LPSC) on potential LPSC rules governing relationships between regulated electric utilities and their affiliated entities operating in unregulated markets.

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 or the efficiency of the economy. 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 staff of the FTC has a longstanding interest in regulation and competition in energy markets, including proposals to reform regulation of the natural gas and electric power industries. The staff has submitted numerous comments concerning these issues at both the federal and state levels.(2) Moreover, the FTC has reviewed proposed mergers involving electric and gas utility companies.

The LPSC staff has noted that affiliated interest standards will need to be developed to "prevent unfair competition and cross-subsidization between affiliated businesses."(3) Sections II through IV of our comment discuss the trade-offs between preventing discriminatory behavior by the parent utility and preserving economies of vertical integration with its affiliates that are central to the development of affiliate rules. We evaluate the potential costs and benefits of behavioral unbundling versus structural separation of distribution companies from their affiliates.(4) We conclude that permitting utilities to own affiliates, but requiring that the affiliates be operated independently, is a reasonable initial approach. The LPSC, however, may wish to reevaluate the trade-offs and alternatives at a specific future date, based on its experience during the interim.

Section V discusses the need for behavioral rules to prohibit favoritism or discrimination in transactions between regulated parent utilities and their unregulated affiliates. If the LPSC decides to promulgate such rules, it may wish to add a "market-like" institution to govern transactions between parent utilities and their affiliates, so that a regulated utility's purchases from unregulated affiliates would be limited to contracts won through an objective bidding process in which a third party evaluates the bids. This arrangement is likely to allow an affiliate to participate in unregulated markets yet preserve any significant vertical economies with the parent utility. Experience in other settings suggests that this bidding arrangement can work if there is confidence in the objectivity of the bid evaluation process.

If the LPSC considers adopting rules permitting an affiliate to use the corporate name or logo of the regulated parent firm with the proviso that such use be accompanied by a disclaimer, Section VI notes that the LPSC may wish to conduct consumer testing to assure itself that such a disclaimer is sufficient to avoid consumer deception. However, it may be difficult to establish an effective disclaimer.

II. Benefits and Costs of Separating a Utility from Its Affiliates

The LPSC is justifiably concerned about effects on consumers and competition of potential discrimination and cross-subsidization in transactions between regulated distribution utilities and their unregulated affiliates providing retail electric and gas services.(5) These concerns are increasing as states implement regulatory reform in the electric industry by requiring vertically integrated monopolies to unbundle various services. The basic policy issue concerns how to balance the expected benefits and costs of separating regulated utilities from their unregulated affiliates. The Public Utility Commission of Texas has noted that this trade-off should be analyzed with a recognition of utilities' continuing incentives:

[T]here is a strong likelihood that a utility will favor its affiliates where these affiliates are providing services in competition with other, non-affiliated entities. . . . [In addition,] there is a strong incentive for regulated utilities or their holding companies to subsidize their competitive activity with revenues or intangible benefits derived from their regulated monopoly businesses. . . . Finally, . . . current regulations . . . are not adequate to prevent or discourage [this] anticompetitive behavior. . . . However, the Commission is aware that efficient competition is fostered by encouraging the participation of many qualified participants, including unregulated affiliates.(6)

The potential benefits to consumers from preventing discriminatory transactions and cross-subsidization between regulated distribution utilities and their unregulated affiliates can take several forms. First, discrimination and cross-subsidization may artificially increase the costs of the regulated utility as costs incurred for the benefit of the affiliate are shifted to the regulated firm. Under a rate-of-return regulatory regime, higher costs will result in increased prices in the regulated market. Second, such conduct may increase costs in unregulated markets by displacing innovative, lower-cost suppliers and entrants with a higher-cost affiliate of the local regulated distribution utility. Third, this displacement also may eliminate or reduce the process and product innovations that the displaced firms would have provided to consumers.

On the other hand, unbundling can impose costs on consumers in the form of lost economies of vertical integration and forgone economies of scale or scope.(7) These lost economies translate into higher costs and higher prices in either the regulated or unregulated markets. In addition, participation by affiliates may in itself increase competition in relevant markets.

In weighing the trade-offs between preventing discrimination and fostering economies of vertical integration, it is important to keep in mind that these questions arise in a broader context of introducing competition into a very large industry with widespread effects on local economies as well as the national economy. For competition to take hold quickly and effectively in these formerly regulated markets, it may be particularly important to dispel potential entrants' perceptions that the incumbent distribution firms will manipulate rules and mislead regulators to the disadvantage of new competitors.

This perception issue gains urgency to the extent that entry may be less costly when competition is being introduced initially in the electricity industry because consumers and businesses are likely to be more aware of and interested in new choices. Conversely, entry may be more costly and less likely in the long run if an incumbent retains incentives to increase the risks of entrants into markets served by the incumbent's affiliates. These broader concerns about entry are not as relevant to state regulators when an affiliate is operating in competitive markets that are less closely related to the markets supplied by the regulated incumbent. Accordingly, the need to address (and reduce) the perception of potential discrimination and cross-subsidization may be greatest when competition is just getting underway.

III. Initial Assessment of Efficiencies Due to Vertical Integration

Before going forward with consideration of behavioral rules for affiliate relationships, the LPSC may wish to assess whether significant existing or prospective economies of vertical integration will be lost when affiliates are operated independently. Such an assessment could alleviate some uncertainty about the costs and benefits of different policy options. If economies of vertical integration are minimal, divestiture at the outset of regulatory reform may be more appropriate than applying behavioral rules. Conversely, if economies of vertical integration are substantial, the LPSC may wish to consider whether any type of separation of a utility from its affiliates is likely to yield net benefits. Recent empirical evidence suggests that economies of vertical integration in the electric industry may be material, but that they vary considerably in different circumstances and may be realized through alternative organizational arrangements.(8) Given this evidence, it seems reasonable to assume initially that vertical integration produces at least modest economies.

IV. Benefits and Costs of Potential Remedies for Market Power

As a general proposition, we have found that structural remedies to address market power, such as divestiture in merger cases, are the most effective and require the least amount of subsequent monitoring by government agencies. The effectiveness of structural remedies stems from the fact that they directly alter incentives. Divestiture, however, may be costly in terms of both transaction costs and irreversibility.

Behavioral remedies, in contrast, leave incentives for discriminatory behavior in place. They also are likely to impose a substantial burden on government agencies to monitor subsequent conduct. Because behavioral rules leave incentives to discriminate in place, active monitoring and enforcement of such rules are essential if the rules are to appreciably curtail discrimination.

In two comments to the Federal Energy Regulatory Commission (FERC), we discussed this type of trade-off and recommended alternative approaches that appeared less costly than divestiture. Each approach sought to capture the benefits of structural remedies while retaining economies of vertical integration and allowing additional firms (the affiliates) to participate in unregulated markets. In 1987, when the industry undergoing deregulation was natural gas pipelines, we suggested that FERC prohibit marketing firms from using their affiliated natural gas pipelines, but we did not recommend vertical divestiture or rate regulation.(9) In 1995, we suggested that FERC promote ISOs to control the regional electric transmission grids as an alternative either to ordering divestiture of transmission lines or to relying solely on open access rules to promote competition in electric generation markets.(10)

Even if the LPSC determines that affiliate rules are likely to preserve significant economies of vertical integration without harming competition, the LPSC may nonetheless specify a future date to review whether these projected economies are realized.(11) At that time, it may be appropriate for the LPSC to review the experience of other jurisdictions that have prescribed different kinds of affiliate rules.(12) The LPSC may wish to move to a divestiture policy if its subsequent policy review indicates that (1) behavioral rules are inadequate to prevent discriminatory conduct or cross-subsidization by affiliates or parent utilities (or are too costly to enforce), and (2) the benefits of preventing such conduct outweigh the forgone economies of vertical integration.

V. Limits on Transactions Between Utilities and Their Affiliates

The LPSC may wish to consider certain behavioral rules to discourage discrimination in transactions between regulated utilities and their unregulated affiliates. As discussed above, we have significant reservations about the effectiveness of relying exclusively on behavioral rules. If the scale, scope, or vertical integration economies of affiliation are substantial and can be realized even in the presence of functional unbundling, the LPSC may wish to consider strengthening behavioral rules by requiring the affiliates to operate independently, on a bid-based, arm's-length basis. For example, the LPSC may wish to require that the bulk of regulated utility purchases from unregulated affiliates be restricted to contracts won through an objective bidding process in which a third party evaluates the bids.

A critical element of workable bidding systems is the perceived and actual objectivity of the bid evaluation process. The system must be perceived as objective in order to attract bidders. Potential bidders, other than affiliates, may be unwilling to incur the costs of making a bid if the system is perceived as biased in favor of affiliates. The system must also be objective in fact in order to avoid raising costs for customers of the regulated utility. The use of third-party evaluations of the bids is one technique for achieving such objectivity.(13)

A question addressed by some state regulators is whether non-energy affiliates would be covered by antidiscrimination rules. Although it is likely that electric distribution company affiliates have no inherent market power in non-energy-related markets, we are less sanguine about potential cross-subsidization problems, some of which may be difficult to address adequately through appropriate transfer pricing rules. This is discussed below in Section VI. In our view, the argument for arm's-length transactions may apply equally well to energy-related and non-energy-related affiliates. Our concerns about the effectiveness of rules against cross-subsidization apply equally to energy-related and non-energy-related affiliates.

Another issue the LPSC may wish to consider is asset transfers from the parent distribution utility to an affiliate. Some states have adopted particular price bounds for such transfers to assure that ratepayers do not unfairly subsidize the activities of the affiliate.(14) This approach raises issues similar to determining the value of assets in assessing stranded costs. Just as some states have determined that the market is the best gauge to determine the value of generating assets in a stranded cost assessment,(15) the LPSC also may wish to use actual market values, rather than a band of prices, for asset transfers. The arm's-length bid process discussed above is an example of a method to establish actual market values.

VI. Benefits and Costs of Allowing Affiliates to Use the Parent Distribution Firm's Logo

In evaluating potential affiliate rules, the LPSC may wish to compare the benefits and costs of allowing affiliates of regulated distribution firms to use the corporate logo of the distribution firm. One benefit of such use may be to reduce prices in the competitive markets served by affiliates. With access to the parent company's logo, the affiliate is likely to have lower marketing costs that may be passed along to consumers in a competitive market.(16) The lower prices of the affiliate may encourage other firms serving this market to charge lower prices as well, resulting in lower prices for the market as a whole.(17) If consumers accurately perceive the implications of an affiliate's use of the parent utility's logo,(18) a second prospective benefit may be reduced search costs for consumers.

On the cost side, we have identified two potential concerns about the use of logos by affiliates: deception of consumers and cross-subsidization.

(1) Potential Deception: The LPSC may be concerned about the effects on consumers and competition of unrestricted use by unregulated affiliates of the logo of the regulated distribution firm. Harm to consumers and competition may occur if elements of the reputation of the regulated firm are not applicable to the unregulated affiliate, but consumers believe that they are applicable when the unregulated affiliate uses the parent utility's logo.(19) For example, an element of a parent firm's reputation might be the credibility of its pledges of high-quality service that are backed by the parent's financial stability as a government-franchised monopoly. If a consumer imputed this same credibility to an affiliate's promises of high-quality service because of its use of the parent's logo, when in fact the affiliate did not have access to the revenues of the monopoly franchise, the consumer could be injured if the affiliate was unable to fulfill its promises in the way the consumer expected.(20) Under such circumstances, the use of the logo by the unregulated affiliate could harm consumers and competition in much the same way as deceptive advertising.

Deceptive advertising is prohibited under Section 5 of the Federal Trade Commission Act.(21) The FTC generally considers advertising deceptive if at least a substantial minority of consumers acting reasonably takes a particular message from an advertisement, and if that message is likely to mislead consumers to their detriment.(22)

Thus, when considering the effect of an affiliate's use of the parent utility's logo, the FTC would consider consumers' impressions about the relationship between the utility and the affiliate and whether those impressions would be likely to affect purchase decisions. If use of the utility's logo implies to consumers that the relationship between the utility and the affiliate is different from what it really is -- an attribute that consumers care about -- such use of the logo could be considered deceptive.

We suggest that the LPSC evaluate the alternatives related to this issue by focusing on the impression that consumers are likely to have under a particular policy alternative, and whether that impression would be accurate. For example, it may be difficult to develop disclaimers that are simultaneously sufficient to avoid deception and succinct enough not to make impractical the unregulated affiliates' use of the regulated parent utility's logo. Consumer research designed to investigate the effects of several alternative policies on consumers may be the most effective approach.(23) If research reveals that consumers are harmed by this deception, the LPSC may wish to restrict further an affiliate's use of the parent's logo.

(2) Potential Cross-subsidization and the Use of the Parent Utility's Logo: Although some forms of cross-subsidization may be effectively addressed by transfer pricing rules,(24) other forms may be more difficult to assess. Cross-subsidization could take the form of cost-shifting among inputs used for both regulated and unregulated products, such as the use of a corporate logo in marketing the affiliate's products and services as well as the regulated parent utility's products and services. Costs of shared inputs could be assigned in a biased manner (i.e., with additional costs assigned to the regulated side of the business) so that the regulated entity can justify higher rates. This biased assignment of costs, which is often difficult for regulators to detect and remedy, distorts competition and produces inefficiencies in the unregulated business as well.

The risk of failing to detect anticompetitive cross-subsidization is heightened if (1) the reputation of the regulated parent utility is effectively embodied or represented by its logo; (2) the regulated parent firm can improve its reputation by incurring costs of the type that regulators would traditionally include in the rate base of the regulated firm; and (3) the unregulated affiliate can enhance its own reputation among consumers by using the logo of the regulated parent firm, even if elements of the regulated firm's reputation do not apply to the affiliate. When these factors are present, a regulated incumbent will have a heightened incentive to overinvest in reputation-building because it can expect to incorporate a greater share of these investments into its rate base than if the assets were not shared with the affiliate. Moreover, the affiliate would realize additional profits from its increased sales in the unregulated market. The principal obstacle to deterring this conduct is that it may be extraordinarily difficult to distinguish competitive from anticompetitive levels of investment in reputation-building. Harm to competition and to consumers may result from such overinvestment and subsequent cross-subsidization.

Harm to competition may occur because the unregulated affiliate's access to the logo of its regulated parent gives it a cost advantage through potential cross-subsidization that otherwise equally efficient competitors cannot match. The anticompetitive results may include (1) higher-than-necessary average operating (i.e., non-logo-related) 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;(25) and (3) discouragement of potential entry that likely would have occurred absent the cross-subsidization, including entry involving innovative products and production processes. If the LPSC finds this concern to be important, it may wish to recognize that transfer pricing rules may not address all of the significant forms of cross-subsidization, and thus may wish to consider ordering the divestiture of unregulated affiliates.

If the LPSC determines upon more detailed study that substantial economies of vertical integration cannot be realized without allowing affiliates to use the logos of their regulated parent utilities, the LPSC may wish to consider an alternative policy of requiring that the affiliate (and any other firms granted the right to use the logo) pay the parent for the right to use the logo.(26) Because the logo is an asset, use of the logo by other firms, including affiliates, represents an asset transfer from the parent firm, and the LPSC may wish to treat it like other asset transfers.(27) In order to avoid cross-subsidization in such a transaction, the use of the parent logo must be fairly evaluated.(28)

VII. Conclusion

The LPSC may wish to establish a set of rules designed to strike a balance between preventing discriminatory conduct by utilities and their affiliates and preserving possible economies of vertical integration. Such rules may be a reasonable initial approach if there are both (1) significant economies of vertical integration between regulated utilities and their affiliates operating in unregulated markets, and (2) net benefits to be gained from separating regulated utilities and their unregulated affiliates. If this is the case, the LPSC may wish to set a date to reevaluate the adequacy of the rules it has adopted, with a view to moving to full divestiture if the rules have not prevented discrimination and cross-subsidization, or have proven very costly to enforce effectively.

In the area of consumer protection, the LPSC may wish to adopt rules on advertising by affiliates that are consistent with FTC law on deceptive advertising.

Finally, the LPSC may wish to evaluate incentives to overinvest in reputation-building if affiliates are allowed to use the parent firm's logo.

Respectfully submitted,

____

Jonathan B. Baker, Director
John C. Hilke, Electricity Project Coordinator
Bureau of Economics
Federal Trade Commission

October 30, 1998

1. This comment represents the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner.

2. The staff of the FTC has submitted comments to various state agencies, including the Commonwealth of Massachusetts Department of Telecommunications and Energy, DTE 97-96 (affiliate standards of conduct)(Oct. 8, 1998); Public Utilities Commission of Nevada, LCB File No. R087-98, PUCN Docket No. 97-5034 (affiliate rules) (Sept. 22, 1998); Louisiana Public Service Commission, Docket No. U-21453 (stranded costs) (Aug. 7, 1998); Michigan Public Service Commission, Case No. U-11290 (electric restructuring) (Aug. 7, 1998); West Virginia Public Service Commission, Case No. 98-0452-E-GI (electric restructuring) (July 15, 1998); Commonwealth of Virginia, Joint Subcommittee Studying Electric Industry Restructuring, SJR-91 (July 9, 1998); Public Utility Commission of Texas, Project Number 17549 (affiliate transactions) (June 19, 1998); Maine Department of the Attorney General and Public Utilities Commission, "Interim Report on Market Power in Electricity" (May 29, 1998); Louisiana Public Service Commission, Docket No. U-21453 (market power) (May 15, 1998); California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032 (electric industry restructuring)(Aug. 23, 1995); and South Carolina Legislative Audit Council (section on foreign experience in electric industry restructuring) (Feb. 28, 1994). The staff of the FTC has commented to the Federal Energy Regulatory Commission (FERC) on electric industry competition and regulation in Docket RM98-4-000 (Sept. 11, 1998); Docket No. PL98-5-000 (May 1, 1998); Docket Nos. ER97-237-000 and ER97-1079-000 (Feb. 6, 1998); Docket No. RM96-6-000 (May 7, 1996); Docket Nos. RM95-8-000 and RM94-7-001 (Aug. 7, 1995) (Open Access Comment). In addition, the FTC staff has commented to FERC about natural gas deregulation in Docket No. RM88-13-000 (capacity brokering) (1988); Docket No. RM87-5-000 alleged

anticompetitive practices of pipeline marketing affiliates (1987) (Pipeline Comment); and Docket No. RM85-1-000 (pipeline regulation after partial wellhead decontrol) (1985).

3. LPSC Staff Report and Public Interest Determination, Docket No. U-21453 at 28 (Dec. 17, 1998).

4. Behavioral unbundling rules proscribe specific behavior between a parent and its affiliate, but do not remove the parent's profit incentives to engage in such behavior.

5. Under fully implemented retail competition, it is expected that both generation and final sales to end users (such as residential consumers, businesses, schools, etc.) will operate competitively with no price regulation. Meanwhile, distribution and transmission services are likely to remain regulated, given current technology. The formerly regulated local monopoly suppliers generally will be required to unbundle their services when retail competition is initiated. (An exception may occur if the state designates the traditional vertically integrated utility as the "supplier of last resort" to serve customers who do not select a competitive supplier.) To accomplish this unbundling, a traditional utility that is allowed by law or regulation to retain ownership of all its previous assets could, for example, elect to establish separate affiliates that would compete in (1) generating electricity (competing with other generators) and (2) selling electricity to consumers (competing with power marketers, independent power producers, utilities from nearby geographic areas, or the electricity supply pool associated with an Independent System Operator (ISO)). The utility also could establish unregulated affiliates in other industries or in other geographic markets in the electric industry.

6. Promulgation of New Rules Governing Activities Between Affiliates, Public Utility Commission of Texas, Project No. 17549, 23 Tex. Reg. 5294 (May 22, 1998).

7. Economies of vertical integration occur when a single firm's performance of activities at two or more stages of production yields lower average costs. Economies of scale are present if, when all inputs are adjusted optimally, average costs decline as output increases within a firm. Economies of scope are present if average costs decline when two or more products are produced by the same firm. See Jean Tirole, The Theory of Industrial Organization 16-21, 288 (1989).

8. See John E. Kwoka, Jr., Power Structure: Ownership, Integration, and Competition in the U.S. Electricity Industry (1996).

9. Pipeline Comment, supra note 2.

10. Open Access Comment, supra note 2. Unbundling through an ISO is termed "operational unbundling." Unbundling through behavioral rules against discrimination is termed "functional unbundling." Both divestiture and operational unbundling are structural remedies that change incentives to discriminate.

11. One advantage of the LPSC's proposed approach to affiliate transactions (or of an augmented approach, as suggested in the next section) is that it will probably be less costly to revise than a policy of either ignoring potential discrimination or requiring full divestiture of affiliates.

12. Some experience already exists. For example, the California Public Utilities Commission fined Pacific Gas & Electric for failure to comply with affiliate advertising rules. See CPUC Press Release, Apr. 9, 1998 <www.cpuc.ca.gov/news>.

13. For example, Phoenix, Arizona has implemented a system of competitive bidding in which outside contractors compete against government departments for contracts to provide various city services. Before a city agency can submit a bid, however, the Office of the Comptroller, which is an independent entity, must certify that the bid is realistic. John C. Hilke, Competition in Government-Financed Services 16, 67-68 (1992).

14. See e.g., Massachusetts Department of Telecommunications and Energy, Order on Standards of Conduct (DTE 97-96), Section 12.C (May 29, 1998).

15. Edison Electric Institute, 4 Retail Wheeling & Restructuring Report 65 (March 1998).

16. The incremental (marginal) cost of marketing to additional customers is likely to be lower if consumers are already familiar with the logo employed in the marketing effort, since little effort will be required to establish familiarity.

17. If the competing firms do not respond with lower prices, the affiliate likely will gain market share. If so, the average price in the market will be lower, even if competitors do not reduce their prices when the affiliate lowers prices, because of its lower marginal costs.

18. Consumers could view use of the parent utility's logo as a guarantee that the affiliate firm is not a fraudulent operator.

19. We use the term "logo" here to include the logo, name, and other elements used to identify the regulated utility.

20. Arguably, injury could occur even if the affiliate did not renege on its promises, because the actual expected value of the promise is less than the affiliate's use of the parent's logo led the consumer to believe.

21. 15 U.S.C. § 45.

22. See Federal Trade Commission's Policy Statement on Deception, letter to Hon. John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives (Oct. 14, 1983), appended to Cliffdale Associates, 103 F.T.C. 110 (1984).

23. Private parties may submit such evidence from privately funded research. The LPSC, however, may wish to be wary of testing performed on behalf of special interests, and may wish to take steps to ensure that the results represent useful indications of likely consumer impressions and behavior.

24. Transfer pricing rules typically forbid transactions between an unregulated affiliate and its regulated parent utility at prices that fall outside of specified limits. Commonly used boundaries include market prices, embedded costs, and book value.

25. If entry is difficult or delayed, market share gained through cross-subsidization also may have persistent market power effects even after the cross-subsidization has been discontinued.

26. Payments to the regulated distribution firm for use of its logo could reduce prices for distribution services by substituting for revenues that the firm otherwise would be authorized by the LPSC to collect through distribution charges.

27. In some situations, firms may sell the right to use a logo to independent entities, contingent upon conditions and restrictions placed on use of the logo.

28. The Maine Public Utilities Commission has established a method to calculate royalty payments that an affiliate must pay to the incumbent utility for use of the utility's name. The payment is determined according to how soon the utility succeeds in earning its authorized return on equity. Maine Public Utilities Commission, Docket No. 98-077 (June 10, 1998).