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

BEFORE THE NEW MEXICO PUBLIC REGULATION COMMISSION

In the Matter of the Petition of the Utility Division Staff of the Public Regulation Commission for Rulemaking, Adopting NMPRC Rule 460, Establishing a Code of Conduct for Public Utilities and Affiliates Under the Restructuring Act	**Utility Case No. 3106**

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

December 6, 1999

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to present its views to the New Mexico Public Regulation Commission (NMPRC) concerning affiliate codes of conduct in the electric power industry and other industries where public utility firms are active participants. New Mexico is among a large number of states considering regulatory reforms, including affiliate codes of conduct, to bring more of the benefits of competition (lower prices, improved service, and innovation) in the electric industry to its citizens and businesses.

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 electric power and natural gas 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 NMPRC requests comment on the NMPRC Utility Division's proposed code of conduct to govern the relationship and interactions between a public utility and its unregulated affiliates. The proposed code provides a starting point for balancing the interest in preventing anticompetitive conduct by a public utility against the interest in having the public utility benefit from efficiencies of vertical integration that can be passed on to consumers.

The staff of the FTC has analyzed other states' proposed codes of conduct and has recommended that they adopt a cost/benefit approach to analyzing affiliate rules of conduct and other issues.(3) It has long been recognized that affiliate relationships between regulated and unregulated companies may impose a variety of costs. These costs include funding unregulated companies with revenues from regulated companies and having the utility provide preferential treatment to its unregulated affiliates.(4) In addition to these potential threats to competition, there are significant costs associated with regulating this behavior effectively, especially in time-sensitive electric power markets. On the other hand, a public utility may benefit from efficiencies of vertical integration that can be passed along to consumers in the forms of lower prices and broader service offerings.

In these comments, the FTC staff has started with the general proposition that potential cross-subsidization and other forms of vertical discrimination by regulated firms in favor of their unregulated affiliates, plus the costs of regulation, are significant enough that structural vertical separation is likely to be a preferable remedy, unless economies of vertical integration are substantial.(5) Thus, it is critical to have a framework to assess the economics of vertical integration.

This comment elaborates on an analytical framework that both the FTC and the Antitrust Division of the U.S. Department of Justice use in evaluating mergers and that could be applied here as well to consider the economics of vertical integration. In antitrust analysis, only those verifiable efficiencies flowing directly from a proposed transaction are cognizable to offset an increased threat to competition stemming from the transaction. Thus, in assessing efficiency benefits from proposed vertical integration, New Mexico may wish to consider only those efficiencies that reverse the threat to competition arising from the close operating relationship between a public utility and its unregulated affiliates. This analytical framework could be used in preliminarily assessing whether to separate vertically the regulated and unregulated activities of a public utility, as well as in specifically gauging the efficiency benefits of a particular joint activity between a public utility and its unregulated affiliate(s).

In addition to assessing the efficiency benefits of proposed transactions between regulated utilities and their unregulated affiliates, the NMPRC may wish to augment Section 10.1 of the draft code of conduct to more fully treat connection rules for distributed generation (DG) in New Mexico. Such a step may contribute significantly to the development of competition in providing electric power services to New Mexico's citizens and businesses. DG technologies are developing rapidly and may provide unique reliability and cost advantages to electricity users, provided that rules for interconnecting DG to transmission and distribution lines are in place to help provide a fair market test for this new technology.(6)

II. Cost/Benefit Analysis Is an Appropriate Framework for Codes of Conduct

Many of the public policy issues surrounding the appropriate elements in codes of conduct are the same as those involved in preventing discrimination in access to transmission.(7) The basic policy dilemma is how to balance the expected benefits and costs of separating regulated utilities from their unregulated affiliates. As the Public Utility Commission of Texas has noted, an analysis of this trade-off should recognize 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.(8)

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. These lost economies translate into higher costs and higher prices in either (or both of) the regulated or unregulated markets. In addition, although participation by affiliates may in itself increase competition in relevant markets, unbundling may diminish the procompetitive effect.

In the trade-off 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. It may be important to eliminate this perception at the outset of competition, when entry is less costly because, for example, publicly-funded consumer outreach and business education efforts allow more consumers and businesses to be aware of and interested in new choices. Accordingly, the opportunity to address (and reduce) the perception of potential discrimination and cross-subsidization may be greatest when competition is just getting underway.

A. Initial Assessment of Vertical Efficiencies

In previous comments to various states, the staff of the FTC has suggested that the regulatory entities may wish to assess whether significant existing or prospective economies of vertical integration will be lost if they require incumbent utilities to establish affiliates to offer unregulated services (as opposed to offering such services on a vertically-integrated basis).(9) Such an explicit assessment by the NMPRC 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 the proposed behavioral rules. Conversely, if economies of vertical integration are substantial, the NMPRC 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 sometimes be realized through alternative organizational arrangements.(10) Given this evidence, it seems reasonable to assume initially that vertical integration produces at least modest economies, although a case-by-case analysis is recommended.

B. Application to Transactions Between Public Utilities and Their Unregulated Affiliates

The most difficult application of an affiliate code of conduct is likely to occur when a proposed transaction between the regulated utility and its unregulated affiliate substantially increases the likelihood of both anticompetitive effects and efficiency gains. A similar policy balance of competitive concerns and efficiency opportunities forms the core of antitrust policy with respect to mergers and joint ventures. The NMPRC may benefit consumers by applying the lessons and insights of merger analysis, especially regarding these potentially offsetting effects in the context of the proposed affiliate code of conduct.

Within antitrust analysis, only those efficiencies that are specific to a proposed transaction are relevant to the competition/efficiency policy assessment. Efficiencies should not be allowed to counterbalance potential competitive harm if the efficiencies can practicably be obtained through other means, without an accompanying threat of diminished competition. For example, economies of scale might be realized if a regulated utility and one of its unregulated affiliates jointly operated a single billing organization. Such economies would not be specific to this transaction, however, if similar economies could be realized by the regulated utility and the unregulated affiliate through less restrictive means -- for example, by entering into a joint production venture with one or more unaffiliated firms, or by contracting for the service through an independent provider.

In the merger context, the federal antitrust agencies have adopted Horizontal Merger Guidelines that explain how the agencies analyze efficiencies potentially arising from a merger.(11) In particular, the agencies recognize only those merger-specific efficiencies that offset competitive concerns, termed "cognizable efficiencies." Although the following excerpt from the Horizontal Merger Guidelines discusses horizontal mergers, the same analysis is appropriate to evaluate efficiency claims when examining the competitive effects of vertical transactions, because significant competitive problems can arise in either context:

The Agency will consider only those efficiencies likely to be accomplished with the proposed merger and unlikely to be accomplished in the absence of either the proposed merger or another means having comparable anticompetitive effects. These are termed merger-specific efficiencies. Only alternatives that are practical in the business situation faced by the merging firms will be considered in making this determination; the Agency will not insist upon a less restrictive alternative that is merely theoretical.

Efficiencies are difficult to verify and quantify, in part because much of the information relating to efficiencies is uniquely in the possession of the merging firms. Moreover, efficiencies projected reasonably and in good faith by merging firms may not be realized. Therefore, the merging firms must substantiate efficiency claims so that the Agency can verify by reasonable means the likelihood and magnitude of each asserted efficiency, how and when each would be achieved (and any costs of doing so), how each would enhance the merged firm's ability and incentive to compete, and why each would be merger-specific. Efficiency claims will not be considered if they are vague or speculative or otherwise cannot be verified by reasonable means.

Cognizable efficiencies are merger-specific efficiencies that have been verified and do not arise from anticompetitive reductions in output or service. Cognizable efficiencies are assessed net of costs produced by the merger or incurred in achieving those efficiencies.

The Agency will not challenge a merger if cognizable efficiencies are of a character and magnitude such that the merger is not likely to be anticompetitive in any relevant market. To make the requisite determination, the Agency considers whether cognizable efficiencies likely would be sufficient to reverse the merger's potential to harm consumers in the relevant market, e.g., by preventing price increases in that market.(12)

The NMPRC may wish to use this analytical framework in making the preliminary assessment of whether to require vertical separation between a public utility and its unregulated affiliates.

In addition, the framework may be applicable in assessing the efficiency benefits of a particular joint activity between the public utility and its unregulated affiliate(s).(13) Given widespread evidence of continued vertical discrimination concerns in the operation of the transmission grid(14) and regulated utilities' similar incentives to favor their unregulated affiliates in other aspects of their operations, the NMPRC may wish to take into account the strong likelihood that certain joint activities or substantial transactions(15) between a regulated utility and one of its unregulated affiliates, other than an arm's-length purchase in an open market, represent a potential threat to competition. In this regard, the NMPRC may wish to consider requiring that the regulated utility demonstrate cognizable efficiencies sufficient to offset potential anticompetitive effects before the utility may engage in a particular joint activity or consummate a substantial transaction with one of its unregulated affiliates.(16)

III. Conclusion

In developing an affiliate code of conduct, a cost/benefit framework contrasting likely threats to competition with likely efficiency gains is useful. An important insight from application of the antitrust laws, which also use this framework, is that not all efficiencies are relevant. Only efficiencies that are verifiable and specific to the particular utility/affiliate relationship are relevant. The NMPRC may wish to incorporate this principle in its affiliate code of conduct to help provide a basis for evaluating proposed substantial transactions between regulated utilities and their unregulated affiliates. This will help assure that the NMPRC's affiliate code of conduct protects competition.

Respectfully submitted,

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Endnotes:

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 commented to FERC on electric power regulation in Docket No. RM99-2-000 (Aug. 16, 1999) (regional transmission organizations); Docket EL99-57-000 (May 27, 1999) (Entergy transco proposal); Docket RM98-4-000 (Sept. 11, 1998); Docket No. PL98-5-000 (May 1, 1998) (merger filing guidelines); Docket Nos. ER97-237-000 and ER97-1079-000 (Feb. 6, 1998) (New England ISO); Docket No. RM96-6-000 (May 7, 1996) (merger policy); Docket Nos. RM95-8-000 and RM94-7-001 (Aug. 7, 1995) (open access). The staff of the FTC also has submitted comments to various state agencies, including the Public Utilities Commission of the State of California, Docket No. R.98-12-015 (distributed generation) (Mar. 17, 1999) (California Distributed Generation Comment); Alabama Public Service Commission, Docket No. 26427 (restructuring in general) (Jan. 11, 1999) (Alabama Competition Comment); Louisiana Public Service Commission, Docket No. U-21453 (affiliate transactions) (Oct. 30, 1998); Public Utility Commission of Nevada, PUCN Docket No. 97-5034 (affiliate transactions) (Sept. 22, 1998); Mississippi Public Service Commission, Docket No. 96-UA-389 (Transco proposal) (Aug. 28, 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); and Louisiana Public Service Commission, Docket No. U-21453 (market power) (May 15, 1998) (Louisiana Market Power Comment). The comments by the FTC staff are available on the FTC's website <http://www.ftc.gov/be/advofile.htm>.

3. See, e.g., Alabama Competition Comment, supra n. 2.

4. See Alfred E. Kahn, Letting Go: Deregulating the Process of Deregulation 35-36 (1998).

5. Alabama Competition Comment, supra n. 2, at Section V. This and other comments also expressed concern about potential consumer deception when an unregulated affiliate uses the name and logo of its regulated parent utility.

6. See California Distributed Generation Comment, supra n. 2. This comment is attached for the reader's convenience.

7. 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 and existing infrastructure. 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). The utility also could establish unregulated affiliates in other industries or in other geographic markets in the electric industry.

8. Public Utility Commission of Texas, 23 Tex. Reg. 5294 (May 22, 1998).

9. See, e.g., Comment to the Public Utility Commission of Nevada, supra n. 2.

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

11. U.S. Department of Justice and Federal Trade Commission, Horizontal Merger Guidelines, issued April 2, 1992, revised April 8, 1997 (Horizontal Merger Guidelines) <http://www.ftc.gov/bc/docs/horizmer.shtm>. The efficiencies section (Section IV) was adopted in 1997 based, in part, on hearings on changing technology and trade conditions conducted by the Federal Trade Commission in 1996. In 1996, the Horizontal Merger Guidelines were adopted as the framework for antitrust analysis by the Federal Energy Regulatory Commission.

12. Id. at Section IV (emphasis in original; footnotes omitted). In addition, the FTC and the Department of Justice recently have released a draft of proposed "Antitrust Guidelines for Collaborations Among Competitors" that adopt the same efficiency analysis as appears in the Horizontal Merger Guidelines. Federal Trade Commission and U.S. Department of Justice, "Antitrust Guidelines for Collaborations Among Competitors," released Oct. 1, 1999 (Section 3.36) <http://www.ftc.gov/os/1999/9910/jointventureguidelines.shtm>.

13. For example, Section 11.2.3 of the proposed code of conduct generally prohibits a public utility and an affiliate from sharing facilities, goods and services such as telecommunications and computer systems.

14. Much of this evidence is reviewed in the Notice of Public Rulemaking on Regional Transmission Organizations issued by the Federal Energy Regulatory Commission in Docket RM99-2-000 on May 13, 1999.

15. Substantiality may refer to the magnitude, duration, or operational significance of the transaction, or a combination of these and other factors.

16. Although the foregoing discussion has been developed in the context of proposed rather than existing transactions, the same analysis can be applied to an extant transaction between a regulated utility and its unregulated affiliate. Where this analysis results in the termination of an existing transaction with the unregulated affiliate, efficiencies not specific to the transaction are unlikely to be lost to the regulated utility or to society, because these efficiencies can be regained through alternative, less anticompetitive transactions with unaffiliated firms.