



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

**Before the**  
**Public Utilities Commission of Texas**  
**Austin, Texas**

**Chapter 25. Substantive Rules**  
**Applicable to Electric Service Providers**

**Project Number 17549**

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

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**June 19, 1998**

**I. Introduction and Summary**

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to respond to the invitation to comment<sup>(2)</sup> of the Public Utilities Commission of Texas (PUCT) concerning 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.<sup>(3)</sup> Moreover, the FTC regularly reviews proposed mergers involving electric and gas utility companies.

The PUCT has invited comment on eleven topics related to the regulatory treatment of electric utility affiliates. This comment refers to four of the eleven topics identified by the Notice: (i) provisions requiring separation of the utility from its affiliates (topic 3); (ii) limits on the types of transactions between utilities and their affiliates (topic 4); (iii) inclusion of a disclaimer when an affiliate uses its parent utility's logo (topic 7); and (iv) the competitive bidding process (topic 11).

First, the Notice correctly observes that separation of a utility from its affiliates may present fundamental trade-offs between preventing discriminatory behavior by the utility and preserving economies of vertical integration. Our comment discusses these trade-offs and alternative ways of addressing discriminatory behavior. It concludes that the PUCT's proposal -- permitting utilities to own affiliates, but requiring that the affiliates be operated independently -- is a reasonable initial approach. The PUCT may wish to consider reevaluating the issue at a specified date in the future, based on its experience during the interim period.

Second, creating “market-like” institutions to govern the types of transactions between utilities and their affiliates may be a viable system for preventing discrimination. These institutions will allow affiliates to participate in unregulated markets and preserve any significant vertical economies. In addition, experience in other settings suggests that bidding arrangements that mimic these institutions can work if there is confidence in the objectivity of the bid evaluation process.

Third, when unregulated affiliates are allowed to use a regulated parent utility’s name or logo, the parent utility may have incentives to overinvest in building its reputation (as a provider of high-quality services, for example) in ways that are difficult for regulators to detect and prevent. This may result in harm both to competition because the affiliate does not have to expend resources to build its reputation, and to consumers because these expenditures inflate the utility’s rate base. Accordingly, the PUCT may wish to investigate the likely effects on consumers of the use of a utility’s name and logos by unregulated affiliates.

Fourth, the comment observes that the proposed competitive bidding process does not specify whether the PUCT will disclose publicly the price and other terms of the winning contracts between utilities and their respective affiliates. To avoid facilitating collusion among bidders, the PUCT may wish to keep such information confidential, particularly in situations where the bidding process will be repeated.

## **II. Separation of a Utility from Its Affiliates**

The PUCT observes that “. . . there is a clear trade-off between the degree of structural separation between utilities and their affiliates versus the amount of regulatory oversight that is required . . .”(4) We agree with the PUCT’s assessment that

there is a strong likelihood that a utility will favor its affiliates where these affiliates are providing services in competition with other, non-affiliated entities. . . Further . . . 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.(5)

As a general proposition, we have found that structural remedies, 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 lies in the fact that they directly alter incentives. Behavioral remedies, in contrast, leave incentives for discriminatory behavior in place and impose a substantial burden on government agencies to monitor subsequent conduct.

On the other hand, divestiture also may be costly in terms of transaction costs and in terms of irreversibility. In two comments to FERC, we discussed this type of trade-off and recommended alternative structural approaches that appear 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 relevant industry 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 regulations.(6) In 1995, with regard to competition in electric generation and transmission, we suggested that FERC promote independent system operators (ISOs) to control the regional electric transmission grids, as an alternative to ordering divestiture of transmission lines or relying solely on open access rules to promote competition in electric generation markets.(7) Both of these comments are attached.

Similarly, we believe that the PUCT’s approach of allowing utilities to own affiliates, but requiring them to operate independently, on an arm’s-length basis, may be a reasonable initial step. Before adopting its current proposals, the PUCT may wish to assure itself that there are significant existing or prospective economies of vertical integration and that such economies remain when affiliates are operated independently. If there are no economies of vertical

integration, divestiture may be more appropriate now, at the outset of regulatory reform. If arm's-length rules would prevent substantial economies of vertical integration, the PUCT may wish to consider carefully whether operational separation of a utility from its affiliates yields net benefits.

One advantage of the PUCT's proposed approach is that it will probably be less costly to revise than a policy of either ignoring potential discrimination or requiring full divestiture of affiliates. If the PUCT determines that its proposed rules can preserve significant economies of vertical integration, the PUCT may wish to add a provision to review its affiliate rules at a specified future date to ensure that these economies are realized. The PUCT may wish to move to a vertical divestiture policy after its subsequent policy review if (1) the proposals actually prove inadequate to prevent discriminatory conduct by affiliates or parent utilities (or prove very costly to enforce), and (2) the benefits of preventing such conduct outweigh the costs of foregone economies of vertical integration.

### **III. Limits on the Types of Transactions Between Utilities and Their Affiliates**

The PUCT proposes to limit the types of transactions between regulated utilities and their unregulated affiliates so as to make discrimination less likely. For the bulk of potential transactions, the PUCT proposes that utility purchases from affiliates be restricted to contracts won through an objective bidding process in which a third party evaluates the bids.

A critical element in making bid systems workable 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 bidding 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.<sup>(8)</sup>

The provisions on affiliate transactions proposed by the PUCT appear to focus primarily on making transactions between utilities and their affiliates more objective. Although this is a desirable outcome, these provisions do not appear to address another potential concern raised by vertical integration -- cross-subsidization by the parent utility of affiliates that are competing in unregulated markets. This cross-subsidization could take the form of cost-shifting among inputs used for both regulated and unregulated products. Costs of shared inputs, which in the electric power industry might include scheduling and general overhead, 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 cost-based 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. If the PUCT finds this concern to be important, it may wish to recognize that rules requiring arm's-length transactions may not address all of the significant forms of impermissible cross- subsidization, and to give additional consideration to ordering the divestiture of affiliates.

### **IV. Affiliate Use of the Parent Utility's Corporate Name or Logo**

The PUCT proposes to require use of a disclaimer when an affiliate uses the parent utility's name or logo. This proposal attempts to address the concern that an unregulated affiliate's use of its regulated parent utility's name or logo is a particularly difficult form of cross-subsidization to police. This concern is most likely warranted if three conditions are present. First, the reputation of the regulated parent utility must be effectively embodied or represented by its name or logo. Second, the regulated parent utility must be able to improve its reputation by investing in equipment (or human capital), and these investments must be of the type that regulators would traditionally include in the rate base of the regulated utility.<sup>(9)</sup> Third, the unregulated affiliate must be able to enhance its own reputation among consumers by using the name or logo of the regulated parent utility, even if elements of the regulated parent's reputation do not apply to the affiliate.

If these three factors are present, a regulated parent utility may have an incentive to overinvest in reputation-building because it may be able to include all of these investments in its rate base while realizing additional gains in the unregulated market(s) served by its affiliate. The major policy and enforcement problem with this conduct is that

normal investment and overinvestment in reputation-building may be exceedingly difficult to distinguish from each other. Harm to both competition and to consumers may occur from overinvestment and subsequent cross-subsidization.

Harm to competition may occur because the unregulated affiliate's access to the name and logo of its regulated parent gives it a cost advantage 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; and (3) discouragement of potential entry that likely would have occurred absent the cross-subsidization, including entry involving innovative products and production processes.

Additional harm to consumers and to competition may occur if elements of the reputation of the regulated parent utility are not applicable to the unregulated affiliate. For example, an element of a parent utility'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 name or 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.<sup>(10)</sup> Under such circumstances, the use of the logo by the unregulated affiliate could harm consumers and increase the harm to competition in much the same way as deceptive advertising.

False or deceptive advertising is prohibited under Section 5 of the Federal Trade Commission Act.<sup>(11)</sup> In determining whether an advertising representation is deceptive, the FTC generally relies on the principle that if at least a substantial minority of consumers takes a particular message from an advertisement, and if that message is likely to mislead consumers to their detriment, then the advertisement is deceptive.<sup>(12)</sup>

Thus, when considering the effect of an affiliate's use of the logo or name of the parent utility, with or without a disclaimer, the FTC would consider the impression consumers will have about the relationship between the utility and the affiliate and whether such impression would be likely to affect purchase decisions. If use of the utility's logo or name implies to consumers that the relationship between the utility and the affiliate is different from what it really is, such use of the name or logo could be considered deceptive.

We suggest that the PUCT 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.<sup>(13)</sup> Consumer research designed to investigate the effects of several alternative policies on consumers may be the most effective approach.<sup>(14)</sup>

## **V. The Competitive Bidding Process**

The PUCT proposes to require that contracts between utilities and their affiliates be filed with the PUCT, but the PUCT does not specify whether this information will be publicly disclosed. Unless the PUCT has some compelling reason for disclosure of this information, we suggest that it remain confidential in the same way that bids typically remain confidential in unregulated markets. Disclosure of information about the prices and commercially-sensitive terms offered in winning bids of utility affiliates may facilitate explicit or implicit coordinated interaction among competitors by creating a focal point for coordination. This may be of particular concern in repeated bidding situations. Hence, the PUCT may enhance competition by maintaining the confidentiality of this bid information.

## **VI. Conclusion**

The PUCT proposes 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. These proposals, including the bidding rules, appear to constitute 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 the separation between the utilities and their affiliates. If this is the case, the PUCT 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 or have proven very costly to enforce. In the area of consumer protection, the PUCT may wish to adopt rules on advertising by affiliates that are consistent with FTC law on deceptive advertising. Finally, in receiving commercially sensitive information on winning bids, it would be prudent for the PUCT to maintain the confidentiality of such information in order to avoid aiding coordinated interaction among competitors.

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. Inquiries regarding this comment should be directed to John C. Hilke (303-844-3565).
2. 23 Tex. Reg. 5294 (May 22, 1998) (Notice).
3. The staff of the FTC has commented to the Federal Energy Regulatory Commission (FERC) on electric power regulation in Docket No. PL98-5-000 (May 1, 1998), Docket Nos. ER97-237-000 and ER97-1079-000 (February 6, 1998), Docket No. RM96-6-000 (May 7, 1996), Docket Nos. RM95-8-000 and RM94-7-001 (August 7, 1995) (Open Access Comment), and Docket No. RM85-1-000 (1985); to the Maine Department of the Attorney General and the Maine Public Service Commission regarding "The Interim Report on Market Power in Electricity" (May 29, 1998); to the Louisiana Public Service Commission, Docket No. U-21453 (May 15, 1998); to the California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032 (August 23, 1995); and to the South Carolina Legislative Audit Council (February 28, 1994). In addition, the FTC staff has commented to FERC about natural gas regulation. See comments to FERC about pipeline regulation after partial wellhead decontrol (Docket No. RM85-1-000 (1985)); alleged anticompetitive practices of pipeline marketing affiliates (Docket No. RM87-5-000 (1987) (Pipeline Comment)); and capacity brokering (Docket No. RM88-13-000 (1988)).
4. Notice, 23 Tex. Reg. at 5295.
5. Id. at 5294.
6. Pipeline Comment, supra note 3.
7. Open Access Comment, supra note 3.
8. 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 realism of its bid must be certified by the Office of the Comptroller, which is an independent entity. John C. Hilke, Competition in Government-Financed Services 16, 67-68 (1992).
9. Increased operating costs may also improve the parent utility's reputation. In this case, the necessary condition to including these costs in the rate base is that these operating costs are prudently incurred.

10. 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 consumer perceived it to be due to the affiliate's use of the parent utility's name or logo.

11. 15 U.S.C. § 45.

12. 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 (October 14, 1983), appended to Cliffdale Associates, 103 F.T.C. 110 (1984). The FTC's Policy Statement on Deception is attached.

13. It may be difficult to develop disclaimers as proposed by the PUCT that are simultaneously sufficient to avoid deception and succinct enough not to make use of the regulated parent utility's name or logo impractical for unregulated affiliates, given the proposed rules separating the management and financial condition of regulated parent utilities from their unregulated affiliates.

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