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

Before the
ARKANSAS PUBLIC SERVICE COMMISSION

In the Matter of a Generic Proceeding to Establish Uniform Policies and Guidelines for a Standard Service Package

Docket No. 00-148-R

**Comment of the Staff of the
Bureau of Economics and of Policy Planning
of the Federal Trade Commission(1) (2)**

July 6, 2000

I. Introduction and Summary

The staff of the Bureau of Economics and of Policy Planning of the Federal Trade Commission (FTC) submits this comment on the Arkansas Public Service Commission's (APSC) Staff Standard Service Package (SSP) Guidelines.(3) The SSP Guidelines are intended to facilitate the timely development and implementation of the SSP for each existing electric utility operating in Arkansas so that consumers will have uninterrupted service during the transition to retail competition.

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 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 FTC has articulated four general antitrust and consumer protection principles that apply to the transition from regulation to competition in the electric power industry.(4) The staff has submitted numerous comments concerning these issues at both the federal and state levels,(5) and the FTC has reviewed proposed mergers involving electric power and natural gas utility companies.

The Arkansas Electric Consumer Choice Act of 1999 (Act 1556) requires that each incumbent electric utility offer a SSP to all its customers until the customer has elected an alternative energy service provider, or if the customer has not been able to secure an alternative energy service provider. The SSP contains a minimum package of energy and electric power service. Prices for the SSP are frozen at the utility's rates in effect prior to the start of retail competition for a set period of years (i.e., the "freeze period"). If the APSC determines at the end of the freeze period that the electric utility has market power over retail sales of electric power, Act 1556 requires the APSC to determine a fair and equitable method to mitigate such market power so that the electric utility can continue to offer a SSP without harming customers. If the electric utility does not have market power, the electric utility is required to continue to provide a SSP at competitive rates.

The APSC staff has proposed SSP Guidelines to implement these provisions of Act 1556. The SSP Guidelines recognize that the nature of the SSP may change as markets evolve and that certain restrictions on the marketing practices of incumbent utilities may be necessary to avoid sustaining or enhancing the market power of an incumbent utility or its affiliates. In addition, the APSC staff has proposed three methods to determine whether SSP prices are consistent with prices in markets subject to effective competition.

The SSP Guidelines provide a reasonable foundation to ensure that consumers obtain the benefits of retail competition -- lower prices, more innovation, wider service choices, and improved reliability. The APSC may wish to take certain steps discussed here to ensure that the transition to competition does not inadvertently preserve or enhance the market power of incumbent utilities and their affiliates. Specifically, the APSC may wish to expand the list of methods that it will accept in assessing whether SSP pricing is consistent with pricing in markets subject to effective competition. If the APSC determines that an existing electric utility has market power in the provision of retail electric power once the freeze period ends, it may wish to examine a wide range of solutions to remedy this market power, including the divestiture of generation assets, the contracting-out of generation to supply SSP customers, or the assignment of customers who have not chosen an alternative supplier to a supplier willing to offer the SSP at a competitive rate. Finally, the APSC may wish to undertake periodic sunset reviews of SSP arrangements after the conclusion of the freeze period in those areas where the utility and its affiliates do not have market power.

II. Consider Additional Steps to Avoid Sustaining or Enhancing Existing Market Power

In a letter providing views to Chairman Thomas E. Bliley, Committee on Commerce, United States House of Representatives, on H.R. 2944 (The Electricity Competition and Reliability Act), the FTC identified four leading principles for effective restructuring of electric power markets. Briefly, these principles include: (1) unburdening of markets from substantial and durable horizontal market power; (2) removing incentives for vertically integrated firms to engage in undue discrimination and cross-subsidization; (3) fostering accurate, non-deceptive information disclosure to customers about price and service offers; and (4) promoting uniform disclosure of terms, prices, and relevant attributes of offers to customers.(6)

The four principles reflect the general perspective that competition in electric power markets will work best when customers have access to the full set of tools they have in other markets to effectively pursue their own preferences. Indeed, fully effective competition in the electric power industry requires informed consumers. And fully effective consumer protection requires that consumers have choices among competitive suppliers.(7) Consumers in electric power markets are likely to be better able to promote their interests when a substantial portion of them can readily switch among several suppliers offering a variety of products and services and where the prices and terms can be readily compared. During the FTC's Public Workshop on electric power industry regulatory reforms, many panelists discussed the possibility of inadvertently sustaining or enhancing existing market power of incumbent utilities (and their affiliates).(8) Existing market power threatens to undermine the benefits of increased competition that otherwise would likely arise from regulatory reform and restructuring. In particular, two elements were discussed at the workshop: (1) the marketing strategies of incumbent utilities,(9) and (2) the "shopping credit"(10) available to customers searching for an alternative supplier.(11) Both of these issues have the potential to inadvertently sustain or enhance an incumbent electric utility's existing market power.

The SSP Guidelines restrict various marketing strategies of incumbent utilities and their affiliates in the event the APSC determines the utility and its affiliate(s) have market power. For example, the SSP Guidelines limit certain long-term contractual arrangements between an incumbent electric utility (or its retail affiliates) and customers that could preclude competition for customers after the freeze period.(12) This limitation is consistent with the DOJ/FTC Horizontal Merger Guidelines, which recognize that long-term contracts with customers may constitute impediments to entry.(13) In addition to this limitation, the APSC may wish to consider constraints on misleading promotional claims by affiliates or any other suppliers. In previous comments, the FTC staff has expressed concern that promotional campaigns by affiliates using the utility's name and logo may be misleading to consumers if, for example, the affiliate is not backed by the assets, revenues, and expertise of the parent utility.(14)

Another insight from the FTC's Public Workshop was that the magnitude of the shopping credit (or, in this case, the price of the SSP) can have a substantial effect on the degree of customer interest in shopping for an alternative electric power supplier where stranded cost recovery has been authorized.(15) A higher shopping credit prompts more customer search activity and more suppliers offering service. In Pennsylvania, a large portion of customers (and an even larger proportion of loads) have selected alternative suppliers because the shopping credits in major areas of the state are relatively large. The trade-off, however, has been that the stranded cost recovery period in Pennsylvania will be relatively long (approximately 10 years).(16) By contrast, consumer search for alternative suppliers has been limited in California, particularly among residential customers, because the shopping credit is relatively small. The stranded cost recovery period in California was limited to four years.(17) Thus, the level of the shopping credit that the APSC establishes will likely have a substantial impact on customer incentives to search for and choose an alternative energy supplier where stranded cost recovery has been authorized.

If an electric utility is authorized to recover stranded costs, the APSC may wish to guard against a potential unintended consequence in setting the shopping credit that allows the incumbent firm to use stranded cost recovery to deter more efficient and innovative entry and, thereby, increase its profits by delaying or otherwise harming competition during the freeze period.(18) Once the freeze period ends in Arkansas, entry incentives for alternative suppliers will no longer be affected by transition charges, and incumbent utilities will no longer have incentives to offer artificially low energy prices that discourage efficient entry of alternative suppliers.

III. Expand the List of Methods Allowed to Show that SSP Pricing Is Consistent with

Pricing in Markets Subject to Effective Competition

Act 1556 provides that after the freeze period (one or three years, depending upon whether stranded costs are recovered), the APSC must determine whether an electric utility has market power. The SSP Guidelines propose that before an electric utility offers a SSP based on market prices, the APSC must determine that the utility and its affiliates do not have market power over generation (or other services proposed for market-based pricing) and that the SSP price is consistent with prices in a market subject to effective competition. The APSC may wish to expand the measurement methods authorized in the SSP Guidelines for determining that a utility's SSP prices are consistent with prices in a market subject to effective competition.(19) The proposed list of approved methods includes competitive solicitation of service, pricing based on a wholesale price index with adjustments to retail, and pricing based on observed market prices.(20) Although each of these approaches has merit, they may miss some factors important in determining competitive prices. Use of statistical techniques (e.g., econometric models) that account for additional sources of differences in prices between geographic markets -- such as the rate of expansion of demand or new, area-specific emissions restrictions -- may provide additional, worthwhile insights. In order to keep open its options with respect to evaluation of SSP rates, the APSC may wish to expand its list of acceptable methodologies to include statistical methods for explaining price levels and changes in prices over time.

IV. There Is a Range of Remedies to Consider Where the Utility or Its Affiliates Have Market Power

The SSP Guidelines specify that each incumbent electric utility must offer a SSP after the freeze period to customers in its territory (and allow the utility to assign responsibility for the competitive components of the SSP to its retail affiliate) if the utility and its affiliate do not have market power. If the utility or its affiliates have market power, the APSC may require that generation for the SSP be opened to competing generators. The effectiveness of opening SSP to alternative suppliers may be limited, however, in areas where existing market power is substantial -- *e.g.*, where the local utility dominates local generation, entry of new generation and transmission involves long lead times, and transmission of electric power from other areas using existing facilities is constrained. When these three conditions are present, the alternative suppliers may not be able to practicably supply a SSP in the area. Where these conditions arise, the APSC may wish to consider restructuring the ownership of existing generation assets through divestiture of the utility's generation assets or other methods.(21)

Alternatively, the APSC may wish to assess the costs and benefits of subcontracting or assigning some SSP load to alternative suppliers so as to lessen the existing market power of incumbent electric utilities.(22) Some states have taken this approach. For example, both Maine and Texas have required that the default or standard service packages offered to customers be subject to competitive bidding among alternative suppliers. Georgia, on the other hand, implemented an assignment procedure to handle the standard service package when it opened its natural gas market to retail competition.(23) Thus, if the APSC determines that a utility has market power once the freeze period ends, it may employ a wide range of options to remedy such market power.

V. Review the Need for the SSP Once Customer Choice Is Well Established in Areas Where the Utility and Its Affiliates Do Not Have Market Power

As the SSP Guidelines note, SSP service is likely to evolve over time as customer familiarity with retail choice increases. At some point, electric power markets are likely to be treated like most markets where suppliers are unregulated. The APSC may wish to periodically reevaluate whether SSP service remains necessary in areas where the utility and its affiliates do not have market power. Once customer choice is well established, the benefits from continued regulation of the SSP suppliers are likely to be small in areas where market power is not found.(24)

VI. Conclusion

In developing its retail choice program, Arkansas has recognized the potential consumer harm that may result from the exercise of existing market power held by utilities and their affiliates. The SSP Guidelines present a reasonable approach to creating a smooth transition to increased competition while retaining regulatory oversight focused on areas with continuing market power. The APSC may benefit customers by improving the SSP Guidelines in selected

ways that correspond to the principles for competitive, consumer-oriented electric power markets, as described above.

Respectfully submitted,

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2. This comment represents the views of the staff of the Bureau of Economics and of Policy Planning 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 or jhilke@ftc.gov).

3. The SSP is available to customers who do not select an alternative electric service provider. The SSP also is available for a customer if the alternative provider fails to perform. The SSP contains energy and electric power service to meet the ordinary demands of a consumer.

4. The principles are discussed more fully in Section II *infra*.

5. The staff of the FTC has commented to FERC on electric power regulation, for example, in Docket No. RM99-2-000 (regional transmission organizations) (Aug. 16, 1999); Docket EL99-57-000 (Entergy transco proposal) (May 27, 1999); Docket RM98-4-000 (Sept. 11, 1998); Docket No. PL98-5-000 (merger filing guidelines) (May 1, 1998); Docket No. RM96-6-000 (merger policy) (May 7, 1996); and Docket Nos. RM95-8-000 and RM94-7-001 (open access) (Aug. 7, 1995). The staff of the FTC also has submitted comments to various state agencies, including, for example, Arkansas Public Service Commission, Docket No. 00-048-R (market power analysis) (April 13, 2000); New Mexico Public Regulation Commission, Utility Case No. 3106 (affiliate codes of conduct) (Dec. 6, 1999); Public Utilities Commission of the State of California, Docket No. R.98-12-015 (distributed generation) (Mar. 17, 1999); Alabama Public Service Commission, Docket No. 26427 (restructuring in general) (Jan. 11, 1999) (Alabama Competition Comment); 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); and Maine Department of the Attorney General and Public Utilities Commission, "Interim Report on Market Power in Electricity" (May 29, 1998) (Maine Entry Comment). The FTC staff comments are available at: <http://www.ftc.gov/be/advofile.htm>.

6. See Letter of the Federal Trade Commission to Thomas E. Bliley, Chairman, Committee on Commerce, on H.R. 2944, The Electricity Competition and Reliability Act (Jan. 15, 2000).

7. We understand that the APSC will separately propose consumer protection measures and request public comments at a later date.

8. FTC Public Workshop on Market Power and Consumer Protection Issues Involved with Encouraging Competition in the U.S. Electric Power Industry, Washington, D.C. (Sept. 13-14, 1999).

9. FTC Workshop, Session IV (Sept. 14, 1999).

10. Under customer choice, "shopping credit" is a term used to describe the difference between (1) the revenue a customer pays to the incumbent utility if he/she remains a customer of that utility, and (2) the revenue this customer pays to the incumbent utility if the customer selects an alternative provider of electric power generation services. If a customer selects an alternative provider, the customer continues to pay the incumbent utility for regulated services (*i.e.*, distribution and transmission) and for recovery of the incumbent utility's stranded costs (*i.e.*, previously incurred generation costs that are not expected to be recovered in a competitive market).

11. FTC Workshop, Sessions I and II (Sept. 13, 1999).

12. SSP Guidelines, Section 3.2.

13. U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, Section 3.3 (issued Apr. 2, 1992; revised Apr. 8, 1997).

14. Alabama Competition Comment, Section V.E., *supra* n. 4.

15. Although existing retail customer choice programs generally assume that a customer will select one supplier, advanced metering and billing technologies are likely to provide consumers with an option to have more than one supplier. With such advanced technologies in place, a customer could, for example, designate one supplier for off-peak periods and another for peak periods, or utilize computer software to automatically switch to the supplier with the most attractive combination of service and price.

16. *See* Ahmad Faruqui, "Electric Retailing: When Will I See Profits?," 138 Pub. Util. Fortnightly 30, 35 (June 1, 2000).

17. *Id*. at 33.

18. *See* Alabama Competition Comment, Section III, supra n. 4. Customers that select an alternative supplier will typically be required to pay a charge for generation services, a lines charge, and a stranded cost recovery surcharge in their monthly electricity bill during the stranded cost recovery period. The incentive for the incumbent utility to set artificially low generation or energy charges arises if the stranded cost recovery policy allows the incumbent utility's reductions in energy charges to be offset by higher stranded cost payments. An incumbent utility's artificially low energy charges can exclude more efficient and innovative alternative suppliers because alternative suppliers do not have access to stranded cost recovery revenues that compensate the incumbent utility for the loss of revenue due to artificially low energy charges. Under the terms of this type of stranded cost recovery policy, the incumbent utility can, in effect, cross-subsidize from the stranded cost recovery charges (where there is no competition) to the energy charges (where there is competition).

19. We recognize that another APSC proceeding (Docket No. 00-048-R) is addressing identification of and remedies for market power.

20. SSP Guidelines, Section 5.4. We note that unrefined price comparisons between geographic areas may be misleading. The difficulty in making comparisons between prices in different geographic markets is that the underlying costs may differ. For example, electric power in areas with high land prices may be relatively expensive because sites for generation and transmission facilities are costly there, even if competition is effective in the area. A simple comparison of rates between Arkansas and an area with higher land costs would give the false impression that SSP prices in Arkansas could increase substantially, yet still be considered competitive. Using an index of electric power price changes in other states or nationally as a benchmark is an administratively non-burdensome approach that avoids many of the complications caused by differing cost conditions in different areas. If SSP prices are to be capped based on a price or cost index over an extended period of time, it may be appropriate to adjust the cap to take productivity improvements into account. One approach is to reduce the price index adjustment in each period by a productivity improvement estimate. *See* Paul L. Joskow, "Restructuring, Competition and Regulatory Reform in the U.S. Electricity Sector," 11 J. Econ. Persps. 119, 135 (Summer 1997).

21. Other techniques for providing more effective competition in supplying the SSP could include imposing bid caps on generation assets of the utility with market power (assuming SSP service is auctioned), or requiring a utility with market power to lease a portion of its generation assets to independent suppliers. If the APSC finds areas where the utility has market power at the end of the freeze period, the APSC may wish to assess the costs and benefits of alternative techniques to address retail market power.

22. In addition, the APSC may wish to remove unnecessary costs or delays to contracting out or to shedding responsibility for SSP services to independent suppliers. Some potential suppliers of innovative electric power services in an area, such as a supplier proposing to offer time-of-day metering, may realize economies (meter purchasing and installation economies, in this example) that allow them to provide such services only in the event that they are also supplying some or all SSP services.

23. And when Georgia opened its natural gas market to retail competition, it allowed consumers to choose an alternative natural gas provider during a defined enrollment period. Those customers that did not choose a new supplier were assigned to an alternative supplier based on the suppliers' shares of customers that had chosen a new supplier during the enrollment period. This approach to customer choice encouraged both customers and providers to treat retail unbundling as more than just an experiment. Indeed, 80 percent of the customers of the largest utility chose their own supplier rather than waiting for the state to assign them to a alternative supplier. *See* George R. Hall, "Lessons From Georgia: The Benefits," 137 Pub. Util. Fortnightly 32 (May 15, 2000).

24. As part of the sunset review process, the APSC may wish to develop measures of customer familiarity with the option of selecting an alternative retail supplier of electric power. Measures could include, for example, awareness of

the customer choice program, awareness of alternative providers and services, and experience in selecting an alternative supplier.