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

Before the
Public Service Commission of the State of Mississippi

Docket to Consider Competition in the

Provision of Retail Electric Service

Docket No. 96-UA-389

Sub-docket: Cost-of-Service Study and

Detailed Proposal Regarding a Transco

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

August 28, 1998

I. Introduction and Summary

The staff of the Bureau of Economics of the Federal Trade Commission (FTC) appreciates this opportunity to present its views concerning the Transco proposal of Entergy Mississippi, Inc. (Entergy) to the Public Service Commission of the State of Mississippi (PSCM).

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 state and federal levels.(2) Moreover, the FTC has reviewed proposed mergers involving electric and gas utility companies.

Entergy proposes to establish a for-profit, independent transmission company affiliate (Transco) that would manage and operate the transmission lines currently owned by Entergy.(3) Entergy would accomplish this by functionally unbundling(4) its generation assets from its transmission assets and placing the transmission assets in a separate affiliate, which would continue to be owned by Entergy. Transmission fees charged by Transco would be subject to rate caps administered by FERC. Entergy describes various institutional arrangements and regulatory constraints to promote independence of its proposed Transco affiliate, including appointment of a trustee to oversee the transmission assets transferred by Entergy to Transco. Entergy also provides examples of specific efficiencies of vertical integration between the management and operation of the transmission grid and indicates that these efficiencies would be lost under an ISO that only manages the grid.(5)

This comment raises several issues about competition and efficiency that the PSCM may wish to address in its review of Entergy's Transco proposal. Entergy's proposal may pose potential vertical and horizontal threats to competition. It also may present potential efficiency benefits, but these likely could be obtained by an ISO that both would manage and operate the transmission grid. As an alternative to Entergy's proposed Transco, the PSCM may wish to consider an ISO structure that would both manage and operate the transmission grid, so as to avoid the potential vertical and horizontal threats to competition posed by Transco while capturing the vertical integration advantages identified anecdotally by Entergy.

II. Entergy Continues to Have Incentives to Vertically Discriminate Against, and Raise Costs of, its Competitors in Electricity Sales (Including Generation)

Entergy proposes a wide variety of rules to establish the independence of Transco, including an independent trustee arrangement. The proposed arrangements may be inadequate for the same reasons that we expressed reservations about FERC's open access rules in our Open Access Comment.(6) Behavioral rules leave in place the basic incentives (created by ownership of generation assets) to discriminate in transmission.(7) In particular, Transco's management knows that its owners (Entergy) will benefit from certain of Transco's practices that favor Entergy's generation assets, such as understating available transmission capacity to independent generation sources. Further, discrimination by Transco management favoring Entergy's generation facilities likely would be difficult to detect and document because such transactions are very sensitive to timing and nuance. Our experience in enforcing the antitrust laws and in monitoring deregulation and restructuring of regulated industries strongly supports a preference for operational separation or divestiture in unbundling services.

Even if Entergy's proposal were likely to be an effective substitute for operational separation or divestiture, potential entrants are likely to perceive a continued risk of discrimination in transmission services based on past experience in the industry.(8) This perceived risk of discrimination is likely to lead to less entry into generation and less competition under a Transco regime than under an ISO regime. The PSCM may wish to consider the actual and perceived risk of discrimination associated with the proposed ownership structure.

III. Incentives to Reduce Competition Between Transmission and Generation Investments

A regulated, for-profit Transco may refrain from taking actions that would increase competition between transmission and generation alternatives (for example, in addressing load pockets(9)). To a considerable degree, expansions of transmission capacity and new or expanded generation within a load pocket are substitutes for each other in relieving such load situations. Without such relief, prices in the load pocket may increase at peak demand periods due to sheer scarcity of supply or due to exercise of market power within the load pocket.

The competitive danger is that Transco may have incentives to favor its own transmission assets relative to any generation source, thereby discouraging new generation sources in the load pocket.(10) For example, Transco could delay connecting a new generator to the grid within the load pocket. By taking such an action, Transco could collect the maximum transmission rates for more hours per day and for a longer period than it would otherwise because of the increased use of its transmission capacity from outside the load pocket.

In light of this possible anticompetitive behavior, the PSCM may wish to consider the incentives to discriminate between transmission and generation relief for load pockets as a cost of the Transco proposal. By contrast, an ISO would have no ownership incentives to favor one type of asset over another.

IV. Efficiency Advantages of Vertical Integration Also May Be Available Through an ISO that Both Manages and Operates the Transmission Grid

Entergy presents examples of specific cost savings that it believes it has achieved because of its vertical integration between management and operation of transmission assets.(11) It maintains that these efficiencies would be retained under its Transco proposal and lost under an ISO that would only manage the transmission grid. The implied assumption of Entergy's proposal is that an ISO cannot operate transmission assets. Although current U.S. ISOs do not operate the grid in their respective areas, there is no reason why an independent, non-profit ISO could not both manage and operate the grid.(12) For example, the British ISO both operates and manages the grid.(13) Indeed, the British ISO owns the grid(14) and could be termed a Transco. It operates, however, under rate caps and is a non-profit association of distribution customers and generators, with oversight by the Director General of Electricity Supply.(15) The PSCM may wish to consider whether the economies of vertical integration identified by Entergy may be obtainable through an ISO that both manages and operates the transmission grid, as well as through the Transco proposed by Entergy.

V. Conclusion

The Entergy Transco proposal entails two significant potential threats to competition and no unique efficiency benefits. The proposal presents anecdotal evidence of efficiencies that it attributes to vertical integration between the management and operation of the transmission grid. If the PSCM determines that such efficiencies are compelling, it may wish to consider an ISO that would combine the competitive neutrality of an ISO approach with the vertical integration efficiencies that Entergy believes are associated with its Transco proposal.

Respectfully submitted,

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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 Louisiana Public Service Commission, Docket No. U-21453 (stranded costs in the electric industry) (Aug. 7, 1998); Michigan Public Service Commission, Case No. U-11290 (electric industry restructuring) (Aug. 7, 1998); West Virginia Public Service Commission, Case No. 98-0452-E-GI (electricity restructuring) (July 15, 1998); Commonwealth of Virginia, Joint Subcommittee Studying Electric Industry Restructuring, SJR-91 (July 9, 1998); the Public Utility Commission of Texas, Project Number 17549 (affiliate transactions) (June 19, 1998); the Maine Department of the Attorney General and Public Utilities Commission, "Interim Report on Market Power in Electricity" (May 29, 1998); the Louisiana Public Service Commission, Docket No. U-21453 (market power) (May 15, 1998); the California Public Utilities Commission, Docket Nos. R.94-04-031 and I.94-04-032 (electric industry restructuring)(Aug. 23, 1995); and the 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 power regulation in Docket RM98-4-000 (Aug. 24, 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).

3. Management of the grid entails making decisions about how, when, and by whom the transmission grid will be used. These are the functions that have been assumed by ISOs in areas such as California and the Pennsylvania,

New Jersey, and Maryland interconnection (PJM). Operation of the grid entails its physical maintenance and improvement. These functions have been retained by the original transmission owners in existing ISOs in the U.S.

4. Functional unbundling of generation assets from transmission assets entails behavioral rules forbidding a vertically integrated utility from discriminating against independent generation sources in granting access to the utility's transmission assets.

5. For example, Entergy claims that because of integrated teams of planning and operations engineers, it has been able to develop solutions to transmission problems that planning engineers alone could not have developed. Proposal, Appendix A at 1.

6. The FTC Bureau of Economics staff's Open Access Comment to FERC can be obtained from the FTC's website < http://www.ftc.gov/be/v950008.htm >

7. Vertical discrimination and raising rivals' costs are potential competitive concerns in the electric industry because the transmission system is likely to remain a monopoly, with regulatory protections against entry as well as other entry impediments. A vertically integrated monopolist in such circumstances may have incentives to favor its own generation assets and discriminate against competitors by offering inferior or higher-priced access to the transmission grid or by seeking other methods to raise costs of rival electricity suppliers. Absent such upstream market power, the competitive concerns are likely to be less severe.

8. See, e.g., "Petition for a Rulemaking on Electric Power Industry Structure and Commercial Practices and Motion to Clarify and Reconsider Certain Open-Access Commercial Practices," filed with FERC by Altra Energy Technologies, Inc. and others on March 25, 1998.

9. A load pocket exists when transmission constraints are such that additional load in an area must be met primarily with generation facilities inside that area. We have not performed a study of current or prospective load pockets in Mississippi. The PSCM may wish to do so in evaluating the Transco proposal. See the FTC Bureau of Economics Staff Comment to the Maine Office of Attorney General and Public Utilities Commission (1998) for a discussion of generation and transmission alternatives for alleviating load pockets < http://www.ftc.gov/be/v980011.htm > .

10. These incentives exist regardless of whether Transco's transmission prices are constrained by rate regulation.

11. Proposal, Appendix A.

12. It is also possible to envision an ISO that manages the whole grid in its service area and operates the grid in part of this area.

13. See James Barker, Jr., Bernard Tenebaum, and Fiona Wolf, Governance and Regulation of Power Pools and System Operators, World Bank Technical Paper 382 (1997) at 25. This source also compares the structures and governance of ISOs in the United Kingdom; Victoria, Australia; Alberta, Canada; and Norway/Sweden.

14. Id. at 25.

15. Id. at 28, 51.