Before the
United States of America
Federal Energy Regulatory Commission

Solicitation Processes for Public Utilities	**)**	**Docket No. PL04-6-000**
Acquisition and Disposition of Merchant	**)**	**Docket No. PL04-9-000**
Generation Assets by Public Utilities	**)**	

Comment of the
Federal Trade Commission

July 14, 2004

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[1]For the purposes of this comment, "solicitation processes" refers to the procurement arrangements of regulated utilities (or their unregulated affiliates). A primary focus of attention is procurement by regulated utilities of generation contracts. Solicitation processes may also apply to acquisition of generation assets. Typically, the affiliates compete with stand-alone independent generating firms in making sales of energy and assets to utilities.

[2] *See, e.g.*, Letter of the Federal Trade Commission to Thomas E. Bliley, Chairman,

Commission applies established legal and economic principles and recent developments in economic theory and empirical analysis to competition issues. As part of its competition advocacy program, the FTC has issued two Staff Reports on electric power industry restructuring issues at the wholesale and retail levels.[3] The FTC and its staff have also filed numerous competition advocacy comments on electricity restructuring efforts with FERC, the states, and international competition organizations.[4]

II. HISTORICAL AND CONTEXTUAL BACKGROUND

Decisions by firms to make or to buy various inputs required to produce a good or service are an integral part of market economies and have been a focus of economic research.[5] Make-or-buy decisions that are based on objective analyses and criteria often lead to increased efficiency that intensifies competition and benefits consumers. The situation FERC currently

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[3]FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform (July 2000), *available at* <http://www.ftc.gov/be/v000009.htm> (this report compiles previous comments that the FTC staff provided to various state and federal agencies); FTC Staff Report: Competition and Consumer Protection Perspectives on Electric Power Regulatory Reform, Focus on Retail Competition (Sept. 2001), *available at* <http://www.ftc.gov/reports/elec/electricityreport.pdf>.

[4]Related comments include Comment of the Staff of FTC's Bureau of Economics and the Office of the General Counsel, In the Matter of Standards of Conduct for Transmission Providers, FERC, Docket No. RM01-10-000 (Dec. 20, 2001); Comment of the Staff of the FTC Bureau of Economics, In the Matter of Deployment of Wireless Services Offering Advanced Telecommunication Capability, Federal Communications Commission, Docket No. 98-147 (Sept. 25, 1998); Comments of the Staff of the Bureau of Economics, In the Matter of Procedures for Consideration of Contract Rules, Postal Rate Commission, Docket No. RM89-5 (Feb. 20, 1990); Statement of the United States Federal Trade Commission Staff, In the Matter of Inquiry into Alleged Anticompetitive Practices Related to Marketing Affiliates of Interstate Pipelines, FERC, Docket No. RM87-5-000 (Jan. 29, 1987).

[5]When a firm elects to make all of its own inputs, the firm is fully vertically integrated. Decisions on vertical integration may entail detailed considerations of the alternative risks, costs, and benefits of making versus buying inputs.

confronts is that of a regulated utility that operates in the same geographic market as its unregulated affiliates and faces a choice of buying from independent suppliers or effectively making the input by securing it from an unregulated affiliate. FERC already has a policy in place (the *Edgar Policy*[6]) that is intended to promote objective make-or-buy decisions by utilities regarding contracts for power. Because the i

[6]FERC, Boston Edison re: Edgar Electric Company, 55 FERC ¶ 61,382 (1991).

[7]The federal antitrust agencies generally do not review transactions among closely affiliated companies. Antitrust does not view affiliates of a firm as the firm's competitors or as competitors of each other because the management of the parent firm controls the output and pricing decisions of all of its affiliates and has incentives and the ability to coordinate affiliated activities to maximize profits of the parent and all of its affiliates jointly. Hence, if FERC were not to review these transactions, there likely would be no federal review.

concern about discrimination and cross-subsidization in affiliate transactions. These developments have prompted FERC to review its *Edgar Policy*.

In previous comments to FERC and the states, the FTC staff has advocated use of a cost/benefit analysis framework for selecting approaches to discourage discrimination and cross-subsidization.[8] These comments have emphasized the potential of structural separation to prevent discrimination and cross-subsidization by directly reducing or eliminating the incentives to engage in those practices.[9]

By contrast, FERC's *Edgar Policy* applies in those circumstances in which the incentives to engage in discrimination or cross-subsidization still exist. Even within the *Edgar Policy* framework, however, FERC may wish to consider some remedies that are more structural than behavioral.[10] These include, for example, economically appropriate transmission upgrades that expand the scope of the geographic market, elimination of impediments that make entry less likely, divestiture of assets that will reduce the ability and incentive to discriminate or cross-subsidize, and steps to encourage price-responsive demand (such as economically efficient real-

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[8]Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, Public Utilities Commission of Nevada, Regulations Governing Conditions Under Which Affiliates of Distribution Companies May Offer Potentially Competitive, Discretionary or Other Competitive Components of Electric or Natural Gas Service, LCB File No. R087-98 and PUCN Docket No. 97-5034 (Sept. 22, 1998), *available at* <http://www.ftc.gov/be/v980027.htm>.

[9]For example, the FTC staff's central concern with FERC's approach to transmission open access was the continued incentives that a transmission operator would have to discriminate in providing access to unaffiliated generators as compared to its own generation assets. Comment of the Staff of the Bureau of Economics of the Federal Trade Commission, FERC, Docket Nos. RM95-8-000 and RM94-7-001 (Aug. 7, 1995).

[10]Our companion comment in FERC Docket RM04-7-000 places remedy issues in the broader context of FERC's decisions whether to grant market-based rates.

discriminates against independent suppliers that offer lower prices for equivalent service or assets. A second potential source of harm is preferential sales or provision of services by the utility to its affiliates. These practices increase the costs (and rates) of the utility, while they decrease the costs and increase the profits of the affiliate. These practices also discriminate against the affiliate's competitors by charging them higher prices (for services supplied by the utility) than the prices paid by the affiliate.

A. Evasion of Utility Rate Regulation Through Inflated Procurement Prices

In a market with economically efficient cost-based regulation of prices

[14]Although nearly all utilities have authority from FERC to charge market-based rates for wholesale electricity sales, FERC's recently revised market power assessment process may result in certain utilities' loss of market-based rate authority.

paying higher regulated rates to cover the regulated utility's inflated costs.

The same framework may also apply where a wholesale customer depends on a regulated transmission provider (with generation assets in the same geographic market) to act as its agent in acquiring electric power. In this situation, the dependent wholesale customer pays higher prices (and its retail consumers pay higher rates) because the regulated transmission provider, acting as a buying agent, buys at inflated prices for the dependent wholesale customer from the transmission provider's generation affiliates.

B. Evasion of Rate Regulation Through Below-Market Sales to Affiliates

A utility whose exercise of market power is constrained by cost-based rate regulation also may find it profitable to evade rate regulation by cross-subsidizing the costs of its unregulated affiliates.[15] This may entail selling to an affiliate at below-market prices or providing better service to the affiliate than to competitors of the affiliate.

For example, selling supplies or services to an affiliate at below-market prices could allow the parent to prevent the affiliate's bankruptcy by reducing its costs and, therefore, increasing its profits. With the cross-subsidization, the affiliate may face lower costs than its

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[15]Cross-subsidization in this context generally means that the utility with regulated rates is paying more than the market value for the service or asset that it is buying from its unregulated affiliate or that it is selling to its affiliate at below market value (or other preferential terms). Cross-subsidization in this context is distinct from issues concerning attributable or incremental costs, common costs, joint costs, and economies of scale or scope that may arise in determining whether regulated rates for one type of service are cross-subsidizing the regulated rates for another type of service offered by a regulated firm. This type of cross-subsidization issue arises often, for instance in postal ratemaking. *See* Comments of the Staff of the Bureau of Economics, In the Matter of Procedures for Consideration of Contract Rules, *supra* note 4.

[16]Incentives for cross-subsidization may also be present in an electricity retail competition setting. In a retail competition setting, the utility often processes consumers' requests to switch suppliers, including switches to and from the utility's retail marketing

achieve the same evasion of rate regulation and only one is addressed by regulators, utilities will have incentives to utilize the other form.

[17] Other indirect inefficiencies may result as well. Customers may make investment decisions based on geographic and temporal distortions in electricity prices caused by rate evasion.

[18]*See* Jonathan B. Baker, “Responding to Developments in Economics and the Courts: Entry in the Merger Guidelines,” 71 *Antitrust L.J.* 189 (2003) (includes a discussion of the history of the terms “entry barriers” and “entry impediments”). *See also* John C. Hilke and Philip B. Nelson, "The Economics of Entry Lags: A Theoretical and Empirical Overview," 61 *Antitrust L.J.* 365 (1993).

[19]The potential combination of exit of more efficient assets and less timely and likely entry may create an extended period in which production costs of electricity will be higher on average than they otherwise would be. If the exiting assets are owned by smaller suppliers, concentration may also be higher than it otherwise would be, and this may contribute to concerns about the potential for coordinated interaction among the remaining suppliers.

To address the ability of utilities to discriminate in transactions with affiliates, FERC may wish to extend one of its core principles underlying non-discriminatory transmission access. FERC found in Order No. 2000 that independent control of the operation of the transmission system is the best method to prevent discrimination. The same insight is likely to apply to transactions between utilities and affiliates. In particular, FERC may wish to encourage one or more independent third parties to conduct market value assessments of bids in bidding situations or to provide market value assessments of offers from affiliates in non-bidding situations. Third-party assessments also may bring additional objectivity to evaluations of concerns about preferential services provided by a utility to its affiliates. Independent evaluations are likely to make the procurement and sales processes involving affiliates more objective. This objectivity, in turn, is likely to reduce the risk of evasion of economically appropriate rate regulation through discrimination in purchases from affiliates or in cross-subsidization of affiliates' costs (by selling to affiliates at below-market prices).[23]

VI. CONCLUSION

Evasion of cost-based rate regulation associated with discrimination in transactions

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Services, Inc., FERC, Docket No. EC02-113-000 at Section 2 (filed Oct. 7, 2002), *available at* <http://www.epsa.org/Positions/FERC.cfm?what=796&docBody=3225>.

[23]This approach has been applied to situations in which in-house governmental departments compete with outside private contractors to perform certain government-financed services. *See, e.g.*, John C. Hilke, Competition in Government-Financed Services, *supra* note 12, at 16-20, 67-68. For example, in 1979, Phoenix, Arizona, implemented a system of competitive bidding in which outside contractors compete against government departments for contracts to provide various services financed by the city. Before a city agency can submit a bid, however, the Office of the Comptroller – an entity independent of the city administration – must certify that the bid is realistic. The city has saved substantially through this bidding process. A description of this program, its procedures, and the cost savings is available at <http://www.ci.phoenix.az.us/Auditor/public1.html>.

between utilities and their affiliates can harm consumers in wholesale and retail electricity markets and other markets.[24] Although FERC's *Edgar Policy* focuses on utility procurement, similar concerns may arise regarding preferential sales by utilities to affiliates. Either form of discrimination is likely to harm utility customers directly by increasing utility costs and rates. Additional consumer harm may stem from the effects of discrimination on competition in the markets served by the affiliates. Accordingly, FERC may wish to adjust its *Edgar Policy* to include sales by utilities to their affiliates. Detecting anticompetitive discrimination in affiliate transactions is often best accomplished by comparing the proposed affiliate transaction to the market value of the transaction. Objectivity in this process is often best pursued through the use of independent third-party evaluators. FERC may wish to adjust its *Edgar Policy* to more directly reference market values of affiliate transactions and analysis of market values by independent third-party specialists in such evaluations. If discrimination concerns persist, FERC may wish to consider remedies that will make the market structure more competitive and will thus reduce the incentive and ability to engage in anticompetitive discrimination.

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[24]The September 2001 FTC Staff Report, *supra* note 3, explains the close relationship between wholesale and retail electricity markets. Unlike many markets in which inventories held by retailers or wholesalers have a substantial (if occasionally short-term) role in determining prices, inventories have only a de minimis role in electricity pricing because electricity cannot be practicably stored (inventoried) in large quantities. Steven Stoft, Power System Economics: Designing Markets for Electricity at 40 and Ch. 5.1 (2002).