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

Before the
United States of America
Federal Energy Regulatory Commission

Standards of Conduct for Transmission Providers

Docket RM01-10-000

Comment of the Staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission(2)

December 20, 2001

I. Introduction and Summary

The staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission (FTC) appreciates this opportunity to present its views concerning the Federal Energy Regulatory Commission's (FERC) proposed new standards of conduct for natural gas pipelines and transmitting public utilities (jointly referred to as transmission providers).(3) Under the proposal, a single set of standards of conduct would govern the relationship between regulated transmission providers and their energy affiliates, which are often unregulated. We support this proposal to provide comparable regulatory treatment of an affiliate's use of the natural monopoly facilities and assets of the regulated transmission provider because it is likely to assist the development of robust electric power and natural gas markets.

The FTC is an independent administrative agency responsible for maintaining competition and safeguarding the interests of consumers. In this industry, the staff of the FTC often analyzes regulatory or legislative proposals that may affect competition or the efficiency of the economy in addition to its review of proposed mergers involving electric and gas utility companies. 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 Commission has issued two Staff Reports (July 2000 and September 2001) on electric power market restructuring issues at the wholesale and retail levels. The July 2000 FTC Staff Report established a policy framework for increased competition in wholesale and retail electric power markets.(4) The September 2001 FTC Staff Report reviewed those features of state retail competition plans that have provided benefits to consumers and those that have not. It also provided recommendations as to whether states had sufficient authority to implement successful retail competition programs.(5)

FERC has concluded that wide-spread structural and technical changes in the natural gas pipeline industry and in the electric power industry warrant unified and consolidated standards of conduct to govern the relationship between owners of natural gas pipelines and electric transmission facilities and their unregulated energy affiliates. There are two competitive concerns raised by the interaction between regulated transmission providers (whether they are electricity transmission or natural gas pipelines) and their unregulated affiliates.(6) First, it is possible that a transmission provider's market power (which FERC seeks to constrain through regulation) could be transferred to and exercised by its affiliated businesses because the existing standards of conduct do not cover all affiliate relationships by which discriminatory conduct could occur. This could occur, as FERC has noted, through the use of discriminatory

information flows from utilities to their affiliates that are not covered by FERC's existing affiliate standards of conduct. Second, the transmission utility could engage in anticompetitive cross-subsidization in favor of its unregulated affiliates. This conduct adversely affects competition and economic efficiency. For example, cross-subsidization of an affiliate may allow a less-efficient affiliate to expand at the expense of more efficient non-affiliates. The result will be high average costs for the market served by the affiliate and its displaced competitors.

In the Notice, FERC contends that the existing gaps in application of affiliate standards of conduct can be addressed by "consolidating" the electric and gas standards of conduct, broadening the definition of the term "affiliate," narrowing the native load exception

proposed acquisition was that MichCon's incentives to serve and promote onsite generation and other natural gas substitutes for electric power would be curtailed once it became an affiliate of DTE. This potential curtailment was due to DTE's incentives to minimize such reductions in electric power demand from the DTE's electric distribution franchise (and DTE's predominant generation and transmission services). Based on strong indications of existing and potential customer demand that could be served by either natural gas or electric power distribution in the Detroit area, the FTC approved the acquisition only after the parties agreed to divest a portion of the MichCon natural gas distribution system to a new local natural gas distribution competitor. The divestiture was in the form of a perpetual easement agreement between DTE Energy and the entrant, Exelon.

The Commission confronted similar issues with the proposed acquisition of the Gulf South Pipeline Company, a major natural gas pipeline in Mississippi and Louisiana (owned by Koch), by the Entergy-Koch limited partnership.(18) Entergy is the principal electric power supplier/distributor and natural gas distributor in much of Mississippi and Louisiana. The Commission found that after the acquisition, Entergy would benefit from paying its new affiliate, Gulf South, an inflated price for gas supplies because Entergy could retain much of the profit from such an increase and, if undetected, pass the increased costs to ratepayers. To the extent that onsite generators in Mississippi and Louisiana would pay higher natural gas prices after the acquisition, Entergy also could benefit from higher demand for electric power (as existing and future onsite generation are curtailed due to higher natural gas prices). As a remedy, the Commission required increased disclosures and competitive natural gas purchasing procedures that would make inflated natural gas charges easier to detect by state regulators.

The third merger involved the purchase of Panhandle Eastern Pipeline Company and Trunkline LNG Company by CMS Energy Corporation, a combination electric and gas utility company serving broad areas of Michigan outside of the Detroit area.

suppliers separately from generation services); and (2) retail sales of unbundled transmission services (i.e., when transmission services are sold independent of generation to retail customers). The open access requirement does not apply when the owner of the transmission facilities is providing bundled service to its native load customers. For this use, the transmission owner may have preference to the transmission grid over non-affiliated entities.

We found in our investigation of state retail electricity programs that the analog to native load service in a retail competition environment is standard offer service. States typically have required distribution utilities to provide customers standard offer service to those customers that have not selected an alternative electricity supplier, or whose electricity supplier has exited the market. The September 2001 FTC Staff Report noted that certain states, which have introduced retail competition, have not afforded standard offer service providers preferential access to the transmission grid if an Independent System Operator (ISO) in place.(21) Once RTOs are operational and are using market mechanisms to manage transmission congestion to ensure efficient transmission pricing, there will be no need for a native load preference. To this end, we support FERC's proposal to reign in potential anticompetitive effects of the native load preference by, among other things, ensuring that utility employees responsible for securing native load supplies, do not have preferential access to transmission information.

IV. Stronger RTOs May Be Preferable To Relying on Broader Application of Behavioral Rules to Deficient RTO Arrangements

FERC has proposed to require members of RTOs to comply with the proposed standards of conduct if the member still has physical control over transmission assets and, importantly, direct access to transmission information. Where RTO arrangements potentially allow anticompetitive discrimination by virtue of continued physical control over transmission assets, it is reasonable for FERC to seek to prohibit such discrimination.(22) FERC's proposed remedy of applying the affiliate standards of conduct in such situations, however, may be less effective than strengthening the underlying weaknesses in RTO arrangements.(23)

When an RTO member retains control over transmission operations (and, in some cases, information), incentives and opportunities for anticompetitive discrimination may persist within an RTO.(24) Similar concerns arise if RTOs are not fully effective (i.e., independent of transmission owners that also control generation in the same area).

The limited success of behavioral rules in securing open access in transmission services argues strongly for strengthening RTO structural requirements rather than attempting to patch deficient RTO provisions with existing or consolidated behavior rules for energy affiliates. The September 2001 FTC Staff Report (Chapter II) provides further support for this conclusion. The Report discussed how areas with active structural separation of transmission from generation through Independent System Operators had more effective wholesale competition and a better opportunity to establish effective retail competition. It is critical for the RTO formation process to move forward to assist development of competitive electric power markets and to minimize backtracking. It would be unfortunate for progress in the RTO formation process to be turned back due to weaknesses in RTO arrangements that affiliate standards of conduct may not effectively remedy.

V. Conclusion

Based on our antitrust merger review experience, the potential anticompetitive discrimination due to convergence between the natural gas and electric power industries shows that FERC's proposal to broaden and unify the coverage

9. To the extent that FERC's proposal would govern the relationship between transmission providers and affiliates that do not rely on the transmission provider's services, assets or facilities, FERC may wish to determine whether the benefits of applying the affiliate standards of conduct outweigh the compliance costs and lost integration efficiencies associated with these rules.

10. The native load exception to FERC's open access requirement occurs when the owner of transmission facilities provides bundled service (when transmission and generation suppliers are sold together) to its retail customers. States that have moved toward retail competition have generally eliminated the native load exception. September 2001 FTC Staff Report at 20.

11. Standard offer service in a competitive environment is comparable to native load service in a wholly-regulated environment. States typically require distribution utilities to provide standard offer service to customers that do not select an alternative electricity supplier or whose supplier has exited the market.

12. This issue is discussed in the July 2000 Staff Report at 13-18.

13. If real-time retail prices reflect real-time wholesale prices, owners of onsite generators will have strong incentives to run these generators during peak demand periods. This will reduce demand from the grid during peak demand periods when wholesale prices are high. See September 2001 FTC Staff Report at 34-7.

14. *See* September 2001 FTC Staff Report at 28; Consumer Energy Council of America, *Distributed Energy: Towards a 21st Century Infrastructure* (Jul. 2001).

15. *See* note 8, *supra*.

16. Other nonpublic investigations have reinforced such concerns.

17. In the Matter of DTE Energy Company and MCN Energy Group, Inc., File No. 0010067, Analysis of the Proposed Consent Order and Draft Complaint to Aid Public Comment www.ftc.gov/os/2001/03/dreanalysis.htm.

18. In the Matter of Entergy Corporation and Entergy-Koch, LP, FTC Docket No. C-3998 www.ftc.gov/opa/2001/01/entergy.htm.

19. In the Matter of CMS Energy Company and Panhandle Eastern Pipeline Company et al., FTC File 991 0046, Analysis of Proposed Consent Order to Aid Public Comment www.ftc.gov/os/1999/03/cmsanalysis.htm.

20. In the Matter of PacifiCorp and The Energy Group PLC, Analysis of Proposed Consent Order to Aid Public Comment www.ftc.gov/os/1998/02/9710091.ana.htm.

21. September 2001 FTC Staff Report at 21. In the Staff Report, we also described that when access to the transmission grid is based on nondiscriminatory rates, rather than on artificial preferences, the grid will operate more efficiently. We understand FERC is currently not proposing to assert jurisdiction over the transmission rates used to support bundled retail sales, as this issue is currently on appeal to the U.S. Supreme Court in New York et al. v. FERC (00-0568) and Enron Power Marketing Inc. v. FERC (00-0809).

22. In this and other contexts, we encourage FERC and the states to utilize a cost/benefit framework in which potential costs, such as loss of efficiencies from vertical integration and administrative costs, are taken into

24. Notice at 50922.