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

Before the Georgia Public Service Commission

Docket Number 15640 -U

Standards for Determining Whether Natural Gas Prices Are Constrained by Market Forces

Comment of the Staff of the
Bureau of Economics and the Office of the General Counsel
Federal Trade Commission (1)

I. Introduction

The staff of the Bureau of Economics and of the Office of the General Counsel of the Federal Trade Commission (FTC) appreciates this opportunity to present its views to the Georgia Public Service Commission (GPSC) about the Conditions are not competitive if more than 90 percent of firm retail customers in a specific delivery group are served

by three or fewer retail marketers. The GPSC may intervene in retail natural gas pricing if either set of conditions is satisfied.(5)

We offer views on the GPSC's proposal from the perspective of the FTC's fundamental mission of preserving competition in the marketplace. Our competitive analysis framework is presented in the U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines (Horizontal Merger Guidelines).(6) Competition is the cornerstone of our economy. Where there is vigorous competition among sellers, consumers are likely to benefit from lower prices, higher quality, wider variety, and greater innovation.

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 in this industry, 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 of competition issues.

FTC staff has commented extensively on the market power issues raised by state retail restructuring plans for the electric power industry. Many of the issues confronting state regulators as they move from a regulated monopoly model to a competitive model for retail sales of electricity also are present in restructuring retail sales of natural gas. The Commission has released 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.(7) 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.(8) The FTC also has reviewed proposed mergers involving natural gas pipelines and those involving electric and gas utility companies.

The FTC has conducted several investigations involving the natural gas industry that have focused on market power issues. The most recent, publicly disclosed case of this type involved a proposed merger between an electric power distributor (DTE) and a natural gas distributor (MichCon) that both serve the Detroit, Michigan, area.(9) The case was settled with a consent agreement by which the acquirer, DTE, divested a perpetual right to use a portion of MichCon's natural gas distribution system in the Detroit area to a new entrant. The settlement was modeled on release capacity arrangements, which were effectively implemented previously for interstate natural gas pipelines.

In addition, the Commission has recently concluded two investigations of competition in certain gasoline markets. Some aspects of market structure and market dynamics in gasoline markets may be similar to those in the Georgia retail natural gas industry. In March 2001, using the competition analysis principles in the Horizontal Merger Guidelines, the Commission completed an investigation of a spike in reformulated gasoline (RFG) prices that was observed in several Midwest states during the spring and summer of 2000.(10) In May 2001, the Commission closed an investigation of West Coast gasoline markets designed to determine whether observed price differences between metropolitan areas, service disruptions, and abrupt price increases at the refiner, wholesale, and retail levels were the result of illegal conduct by the West Coast refiners.(11)

II. Background of the Proposed Standards

In 1997, the Georgia Legislature established a new regulatory model in Georgia's retail natural gas industry. The Legislature allowed regulated vertically integrated natural gas utilities to unbundle distribution functions from retail sales. "When a company elects to unbundle its distribution and sales functions, as Atlanta Gas Light Company (AGLC) did, the industry is effectively separated into two sectors. One sector, the distribution infrastructure and operations, is assumed to retain the natural monopoly characteristics that require traditional regulation, while the other sector, commodity sales, is assumed to be potentially competitive."(12) In retail commodity sales, prices for natural gas are determined by competition rather than set by regulation. After many reported ups and downs associated with being the first state in the Nation to remove the distribution utility from the natural gas merchant function, the marketplace had winnowed the number of major competing retail marketers in Georgia to four by early 2002.(13)

In April 2002, the Legislature amended the statutory framework governing the regulation of the retail natural gas industry (HB 1568) to address many of the reported problems that had surfaced in the first several years of deregulation. Among other things, it established a default service provider for certain classes of customers and provided customers with a "bill of rights" for natural gas services. The Legislature also authorized the GPSC temporarily to reimpose price regulation on natural gas marketers if prices "are not generally constrained by market forces."(14) The legislation includes a rebuttable presumption that market conditions are not competitive - and thus that retail prices are significantly higher than they would be if they were constrained by market forces - if more than 90 percent of the consumers in a specified delivery group (e.g., residential consumers) are served by three or fewer marketers.(15) This measure of market structure is a three-firm concentration ratio.

Aside from the rebuttable three-firm 90 percent market share screen for market power, the legislation identified additional circumstances in which intervention by the GPSC is authorized. It permits the GPSC to adopt standards for determining whether prices paid by retail customers are "not constrained by market forces" and are "significantly

degree to which alternative choices exist, and the amount of information available to these retail customers about alternative choices.

In the second stage of its analysis to determine if prices are substantially higher than competitive prices and harmful to the affected customers, the GPSC will determine whether one of three price triggers is reached: (1) prices exceed a competitive benchmark by 20 percent over the prior 12 months; (2) prices exceed a competitive benchmark by 30 percent over the prior three months; or (3) current prices exceed a competitive benchmark by 50 percent. The GPSC does not state specifically how it will calculate the competitive benchmark, but it provides a list of cost factors, comparisons to prices in other jurisdictions, and business risk 70.5ies il7-3(t)2(o)111(di)13(c/C3)1. e t-3(pef 0.004 Tc36 0 9]TJ 14.(i)13

relatively small share of customers who would switch in response to price increases often protect other customers - potentially even the majority of customers - who may not have the same ability or willingness to switch.(24)

Because customer choices can have dramatic effects on efforts by incumbent suppliers to exercise market power, the GPSC may wish to evaluate impediments to customer choice. Important issues to consider include barriers to customer switching, the degree to which alternative choices exist, and the amount of information available to retail customers about such alternatives. The GPSC may wish to expand this list or expand its discussion of alternatives to include entry conditions. This would signal to marketers and potential entrants that the GPSC recognizes how entry can dramatically increase customer choices in the face of efforts by one or more incumbent suppliers to exercise market power.

V. Link Market Power Concerns to Structural Remedies and Customer Price Sensitivity, Not Just Behavioral Remedies

The GPSC's proposal contemplates a temporary return to retail price regulation if (under the criteria it adopts) the GPSC determines that suppliers are exercising substantial market power. Price regulation is a behavioral remedy for market power that leaves in place incentives to exercise market power. Our experience in antitrust law enforcement and competition advocacy suggests that structural remedies are preferable to behavioral remedies because the former change suppliers' incentives and are, therefore, largely self-enforcing.(25) Structural remedies change the competitive dynamics of a market by changing the number or relative positions of firms, either directly or by reducing impediments to entry. Accordingly, if the GPSC finds evidence of market power problems, it may wish to review its policies that affect market structure.(26) In particular, if the GPSC finds evidence of nontransitory market power in retail natural gas markets, it may wish to examine whether its policies (or those of other regulatory bodies) are impeding entry or discouraging investments that would increase competition by adding new retail suppliers or removing supply bottlenecks.

Similarly, the GPSC may wish to bolster customers' ability to defend themselves against market power. Policies to improve customer information, and to reduce regulatory lags and costs for customers switching to marketers with lower prices, can serve this purpose by making customers more sensitive to prices, which would increase the price

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of the staff of the Bureau of Economics and the Office of the General Counsel
y are not necessarily the views of the Federal Trade Commission or any
sion, however, has voted to authorize the staff to submit this comment.
d be directed to John C. Hilke, Economist and Electricity Project Coordinator in
40 or jhilke@ftc.gov), or Michael Wroblewski, Assistant General Counsel for
blewski@ftc.gov).

), §§ 515-7-12-.01(1),(2), and (4).

Relief Act," § 13 (enacted Apr. 25, 2002).

of price regulation applied to retail marketers (NOPR, § 515-7-12-.01(2)) or
gulated natural gas distribution firm into regulated retail commodity sales

ere published on April 2, 1992, and revised on April 8, 1997, *available at*
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Consumer Protection Perspectives on Electric Power Regulatory Reform (July
/be/v000009.htm>.

Consumer Protection Perspectives on Electric Power Regulatory Reform,
01), *available at* <http://www.ftc.gov/reports/index.htm>.

erger would reduce competition (for example, by reducing discounts offered by
nvestments in on-site electricity generation fueled by natural gas), because

11. FTC Press Release: FTC Closes Western States Gasoline Investigation (May 7, 2001), available at <http://www.ftc.gov/opa/2001/05/westerngas.htm>. In this matter, the Commission was asked to investigate solely whether there was an antitrust violation. The investigation produced no evidence of conduct that violates the antitrust laws.

12. GPSC Staff White Paper, § I (Jan. 2003). One novel feature of the Georgia restructuring was that all retail customers selected or were assigned to a merchant natural gas supplier. No provider-of-last-resort arrangement was provided for customers who did not select a merchant supplier on their own.

13. Blue Ribbon Natural Gas Task Force, Final Report at 9 (Feb. 5, 2002). Several smaller retail marketers also are active in Georgia. These include two recent entries by electrical cooperatives under the provisions of HB 1568, § 20.

14. HB 1568, § 13. This legislative language is reflected in NOPR, § 515-7-12-.01(1)(b), (2), and (4).

15. HB 1568, §13; NOPR, § 515-7-12-.01(3) reflects this aspect of the legislation.

16. A "firm" retail customer is one whose supply contract does not allow for interruptible service (where the supplier curtails deliveries under a variety of circumstances, usually in return for a lower price on deliveries that do occur). A customer with the latter type of contract is termed an "interruptible" customer.

17. Entry delays may result in high concentration when a market first opens. Some entrants' efforts to attract customers may take time to be effective, and some potential entrants may wait to enter until after initial regulatory uncertainties are resolved.

18. A sunset review may be particularly appropriate as some retail marketers work increasingly over time to differentiate themselves from other retail marketers. This product differentiation could be based, for example, on the quality of service or on service innovations. With such product differentiation, prices may increase because customers prefer retail marketers that offer better or innovative services, even if they charge higher prices. For example, some marketers may offer a service that bundles commodity sales with insurance against volatility in natural gas prices. When natural gas prices are below historic averages, the price of this bundled product could far exceed prices that do not include an insurance component. If such bundled services become popular, it could lead in the future to actual prices that exceed the trigger prices but do not reflect an exercise of market power. If such differentiation becomes a prominent feature in Georgia retail natural gas sales, the proposed approach may become an impediment to satisfying customer preferences.

19. Horizontal Merger Guidelines, § 3.

20. *Id.*, § 2.212.

21. *Id.*, §§ 1.521 and 3.

22. For example, changing market conditions may indicate that the current market share of a particular firm understates or overstates its future competitive significance. This is illustrated by a firm that does not have access to new technology that is important to long-term viability of market participants. In this instance, the current share of the firm in question is likely to overstate its future competitive significance. *Id.*, § 1.521. Similarly, the closeness of substitutes outside the market may affect the significance of a particular concentration measure. Where a wide gap in the chain of demand substitutes occurs at the edge of the product and geographic markets, more market power is at

24. For a discussion of consumer self-defense in the context of electricity retail markets, see John C. Hilke, *A Consumer Self-Defense Perspective on Electricity Markets*, 33 Loy. U. Chi. L.J. 805 (2002). This limitation on the exercise of market power provided by the switching of a small share of customers is less likely to protect other