

In a state with cost-based rate regulation of retail utility prices in which the regulated utility has market power, some mechanism is appropriate to assure that asset transfers from an affiliated generator to a parent utility, for example, do not take place at inflated prices. Rate-regulated parent utilities with market power have incentives to make such transfers. The costs of the inflated asset base for the regulated utility would be covered by higher regulated rates while the gains from the asset sale at an inflated price would be realized by the affiliate outside of the scope of the regulator's cost-based rate determination. A transfer at an inflated price would be a form of regulatory evasion because it would result in the exercise of market power, with captive customers paying higher regulated rates to cover the regulated utility's inflated costs of acquiring generation capacity. These higher regulated rates are likely to distort customers' investment incentives⁽⁶⁾ and their consumption decisions. In the case of the former, the harm can persist long after the rate effects have ceased if the investments made on the basis of distorted price incentives remain in the market.

Establishing market values for affiliate transactions can be accomplished in several ways including putting some of the assets up for sale, doing a "comparables" analysis (including using econometric techniques to develop an estimated market price based on recent sales prices of similar properties), or doing a discounted cash flow analysis of expected earnings. All of these approaches present challenges, but they are likely to be more accurate than using historic book values alone to estimate the market value of affiliates' assets.⁽⁷⁾

III. Will Rebundling Result in the Loss of Benefits Gained by Vertically Unbundling?

Numerous state utility regulators have required electric utilities to unbundle generation from transmission, to place generation assets into unregulated affiliates, and to impose a code of conduct that governs the interaction between unregulated affiliates and the parent utility. These actions are often undertaken as a remedy against discrimination and/or cross-subsidization by a parent utility favoring an affiliated, unregulated generator or marketer. Such discrimination or cross-subsidization can competitively disadvantage equally or more efficient independent generators and marketers and lead to higher system costs, less innovation, lower service quality, and reduced variety of available services for customers.⁽⁸⁾ If the discrimination or cross-subsidization results in an increase in market concentration or a reduced probability of effective entry within an already highly concentrated market, additional harm to customers may occur because of increased exercise of horizontal market power by suppliers.

In a retail competition setting, for example, discrimination may allow the parent utility to preserve or enhance its overall profits by increasing the marketing costs of unaffiliated retail power marketers. One means of accomplishing this objective could be to provide slower or less accurate retail customer switching procedures and services to prospective customers of unaffiliated retail power marketers and associated generators than the parent utility provides to the prospective customers of its own retail marketing affiliate.⁽⁹⁾

Another potentially profitable form of discrimination may occur when the parent utility is subject to cost-based rate regulation that results in underpricing of a service for which there is an excess demand at the regulated price. In such circumstances, the parent utility can discriminate by giving its affiliate priority to this service. In effect, this strategy reduces the affiliate's costs relative to the costs of competing independent suppliers.

A parent utility whose ability to exercise market power is constrained by cost-based rate regulation also may find it profitable to cross-subsidize its unregulated affiliates. As an alternative way to slow the net switching of retail customers to independent retail marketers, the regulated utility could cross-subsidize the processing of requests from

appropriate analysis to the rebundling of assets and associated remedies. For example, state or federal regulators may have relied on unbundling of transmission from generation assets to prevent or eliminate discrimination or cross-subsidization from the regulated parent utility to the unregulated generation affiliate. If so, then rebundling may pose a risk of increased discrimination or cross-subsidization (and associated loss of efficiency) and should be analyzed accordingly. The ICC may wish to consider a policy based on consistent regulatory treatment of unbundling and rebundling.

In general, there is a hierarchy in the effectiveness of different vertical unbundling policies,⁽¹⁰⁾ although the relative costs of these remedies vary in different circumstances.⁽¹¹⁾ Full divestiture is likely to be the most effective remedy since it directly changes the profit incentives of firms.⁽¹²⁾ Divestiture to an affiliate (with accompanying conduct codes prohibiting discrimination as well as separate accounting for the affiliate) is likely to be less effective because the incentives to discriminate and cross-subsidize remain in place and enforcement of such codes may be costly and subject to error. Accounting separation alone is likely to be the least effective because behavioral incentives to discriminate and cross-subsidize remain in place with no countervailing behavioral restrictions.⁽¹³⁾

In a context where the parent regulated utility has an incentive to discriminate or cross-subsidize, the transfer of assets of an affiliated generator to the parent utility means a movement toward relying on accounting separation as the primary policy instrument against discrimination and cross-subsidization. Where actual and potential discrimination and cross-subsidization issues are significant - and where costs of implementing more effective remedies are not disproportionately high -- moving toward an accounting separation enforcement mechanism may threaten competition and promote inefficiency.

IV. Conclusion

The transfer of the assets of an affiliated generator to its parent utility may threaten to increase the exercise of the utility's market power. This may occur either by increasing the incentives to evade regulation or by enhancing the incentives and ability to vertically discriminate against independent generators (and marketers) or to cross-subsidize the affiliate. We encourage the ICC to evaluate both potential sources of customer harm in this and similar proposed transactions. One useful approach may be to consider unbundling and rebundling as equal but opposite transactions.

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Endnotes:

1. This comment represents the views of the staff of the Bureau of Economics and the Office of the General Counsel of the Federal Trade Commission. They are not necessarily the views of the Federal Trade Commission or any individual Commissioner. The Commission, however, has voted to authorize the staff to submit this comment. Inquiries regarding this comment should be directed to John C. Hilke, Economist and Electricity Project Coordinator in

the Bureau of Economics (801-524-4440 or jhilke@ftc.gov), or Michael Wroblewski, Assistant General Counsel for Policy Studies (202-326-2155 or mwroblewski@ftc.gov).

2. On May 30, 2003, AmerenUE filed a notice of withdrawal of its application in this proceeding. Nonetheless, we believe the comment may continue to be of interest to the ICC when it considers similar applications in the future.

3. FERC's Cinergy decision (FERC Docket No. EC02-113-000) of February 4, 2003, for example, raises similar

(FERC Docket Nos. RM95-8-000 and RM94-7-001, filed Aug. 7, 1995) identified operational unbundling (through an